Recommended 2003/2004 Budget
and
Ten-Year Resource Allocation Plan

City Manager's
Letter of Transmittal

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Honorable Mayor and Members of the City Council:

CITY MANAGER'S MESSAGE

INTRODUCTION

I am presenting for your review and consideration the recommended FY 2003/2004 Budget and accompanying Ten-Year Resource Allocation Plan (RAP). In addition, financial projections are provided for a second ten years, ensuring a full 20-year perspective for financial planning. In keeping with Council policy, each fund is balanced to the twentieth year. This has been an especially difficult result to achieve this year.

FY 2003/2004 is the second year of the two-year operating budget cycle. In normal times, the two-year cycle for operating programs was established to recognize the fact that service levels change only modestly from year to year, and that resource requirements can be effectively planned over a two-year time frame. Since most operating programs are not normally reviewed extensively for the second year, a significant amount of staff time is saved. This staff time can be directed toward service delivery, continuous improvement efforts, and Council study items. However, certain key factors in the operating budget, such as major revenue sources, personnel costs and enterprise activities, are reviewed each year in order to ensure the accuracy of our long-term projections. These factors are discussed in more detail later in this Transmittal Letter.

However, we know that these are not normal times for cities, counties, and school districts in California. As we end FY 2002/2003 and plan for FY 2003/2004 and beyond, Sunnyvale is faced with a financial situation that is more difficult than any in recent memory. In the late 1970s, Proposition 13 dramatically reduced property tax revenues to California cities, including Sunnyvale. In the early 1990s, the last economic recession reduced revenues to the City and the State shifted more than $5 million in our property tax revenues to school districts to solve their own budget shortfall. During both of these earlier situations, the City's planning and financial management system allowed us to absorb these substantial reductions without dramatic, long-term effects on services.

Today, the City is faced with three threats to our financial stability:

- The worst economic downturn in the Silicon Valley since the Great Depression, as measured in job loss, has had a dramatic effect on the City's revenues
- Personnel costs are increasing at rates substantially higher than inflation and higher than we previously included in budget projections
- The State is undergoing the most severe budget crisis that it has ever experienced and will be reducing revenues to local governments as part of the solution.

These three factors are beyond the capacity of our planning and financial management system to resolve. Additional approaches and strategies are needed to supplement our systems so that the City can continue to provide a set of services that meet the requirements of our residents, businesses, and community groups at the lowest costs possible.

As the City began FY 2002/2003, we had projected the significant downturn in the local and regional economy and expected to use our existing fiscal strategies to maintain current service levels. These strategies of long-range financial planning, our commitment to setting service levels based on predictable amounts of revenue ("living at the trend line") and our preservation of excess revenues during robust economic times for nonrecurring events and reserves have served us well during previous economic downturns. Unfortunately, economic and fiscal conditions have worsened during FY 2002/2003. This has created a structural gap between ongoing revenues and ongoing expenses in the General Fund. This gap is projected to be $14-15 million annually for the next 20 years. It could grow even larger if revenue projections do not hold, if personnel expenses grow faster than estimated, and if the State of California reduces state-provided funding to cities and counties as a means to solve its budget crisis. Reducing one-time expenses can not close this structural gap. Rather, it requires a fundamental re-examination of the services that we provide, a resetting of levels of services, increases to fees, charges, and potentially local taxes, and a reduction in our workforce. These changes will create the on-going reductions in expenses and increases in revenues that are required to resolve this budget crisis. This new fiscal reality required that the City develop a new fiscal and budget strategy to reduce the size of city government in Sunnyvale.

BUDGET REDUCTION PROCESS

Because of the City's new fiscal reality, we used a different approach to preparing the recommended FY 2003/2004 Budget, Ten-Year Resource Allocation Plan, and Long-Term Financial Plan. Even though the focus should have been primarily on the project budget, <u>the budget crisis demanded that we undertake a comprehensive review of both the project and the operating budgets.</u> The approach for accomplishing this was a 6-Point Action Plan. This action plan was presented and discussed with Council at the Future Fiscal Issues Study Session in January 2003.

The 6-Point Action Plan addressed these topics:

Point 1: Current Capital Projects Plan
Point 2: Rental Rate Schedules and Formulas
Point 3: Job Recruitment and Vacancies Review
Point 4: In-Lieu Fees and Inter-Fund Transfers
Point 5: Tax and Fee Increases
Point 6: Reductions to Services, Levels of Service, and Staffing.

Through this effort, staff throughout the organization identified potential ways to reduce the size of city government in Sunnyvale. This resulted in recommendations that are designed to reduce the "basket of services" that are provided, to reset service levels for those remaining City services, and to reshape and reduce the size of the workforce. The 6-Point Action Plan also examined the fees, charges, and local taxes that produce the revenues needed to provide City services. This effort identified potential increases to existing and new fees, charges, and local taxes that could be enacted in order to raise revenues. The 6-Point Action Plan resulted in a series of reports and recommendations to establish a revised set of City services that are provided by a sustainable workforce for the foreseeable future.

Since January, a series of special reports has been presented to Council at regular and special meetings on the various elements of the 6-Point Action Plan. Council has provided preliminary policy guidance, which has been incorporated into the recommended FY 2003/2004 Budget and Ten-Year Resource Allocation Plan. Community meetings on the budget were conducted to encourage citizen input on the various recommended actions. *Volume IV* of this budget document contains the 6-Point Action Plan and the four special reports.

In addition to these special reports, staff also engaged a market research firm to determine residents' preferences regarding potential service reductions in 45 City services. The community assessment also gathered information regarding residents' tolerance for potential increases to fees, charges, and local taxes rather than reducing service levels. Several meetings were also held with business groups to discuss the budget crisis and the 6-Point Action Plan.

Staff undertook these efforts to give Council additional data and information that can be used in providing preliminary and final policy direction on budget related issues. Several key findings emerged from the community assessments, such as:

- Residents prefer to maintain current service levels and raise fees, rather than reduce service levels and
- Seventy-three percent (73%) of residents would support at least a minor increase to fees, charges, or local taxes in order to maintain services and service levels. Only 27% reported that they did not support any increase.

Volume IV also contains a report that describes other results and key findings in more detail.

I am pleased to report that we have taken significant steps to close the estimated $14-$15 million structural gap between revenues and expenses in the General Fund. This has resulted from the examination and recommendations regarding each point in the 6-Point Action Plan, and the preliminary policy direction that the City Council has provided.

The following chart summarizes how the structural gap can be closed:

Estimated Savings to Reduce Ongoing Revenue to Expense Gap	**Amount**
Capital Projects Plan	$1,800,000
Rental Rates/In-Lieu Fees (Equipment)	$500,000
Department Service Level/Expense Reductions	$8,455,059
Rental Rates (Operating Expenses)	$1,427,019
Set-Asides	$1,250,000
New Revenues	$1,426,000
Grand Total	**$14,858,078**

Following final Council direction, staff will prepare an implementation plan that will be reflected in the Adopted Budget.

The City Council needs to be acknowledged for its recognition and understanding of the depth and severity of the budget crisis we are facing, and for its commitment to identifying a solution to it.

OVERVIEW OF THE PROPOSED PROJECTS BUDGET

In keeping with the separation of the operating and project budget cycles, FY 2003/2004 is the first year of a two-year projects budget. I am recommending $20,213,310 in projects in FY 2003/2004 and a total of $84,173,206 in projects over the ten-year planning period. These figures include the reductions to the Ten-Year Projects Plan that were developed through the 6-Point Action Plan. All projects proposed for the Ten-Year Resource Allocation Plan underwent a thorough review by the Projects Review Committee prior to being recommended to the City Manager. Below is a table containing project expenditures by fund. It should be noted that only new appropriations are reflected within the table.

Project Expenditures by Fund		
Fund	**FY 2003/2004 Recommended Budget**	**10 Year Recommended Budget**
Infrastructure Renovation & Replacement	11,033,123	37,506,550
Utilities	2,120,216	13,457,920
Capital Projects	2,056,980	12,006,006
General Fund	806,026	10,325,268
SMaRT Station	437,719	5,651,768
Housing	1,594,185	1,793,180
Community Development Block Grant	1,479,881	1,479,881
Gas Tax	49,508	763,783
General Services	537,466	595,287
Redevelopment Agency	31,620	346,229
Park Dedication	12,000	154,162
Public Safety Forfeiture	54,586	93,172
TOTAL	$20,213,310	$84,173,206

Details of the projects budget are included in the *Major Project Efforts* section of this Transmittal Letter, in discussion of the individual funds, and in *Volume II Projects Budget.*

THE SUNNYVALE APPROACH TO BUDGETING

As we begin review of the recommended FY 2003/2004 Budget, it is important to understand the key financial and planning systems that Sunnyvale uses to chart its future both in the good times and the bad times. Sunnyvale's approach to budget preparation is a central part of the City's Planning and Management System (PAMS). Key elements of the PAMS framework include:

- Long-range strategic planning (the General Plan Elements and Sub-Elements),
- Long-term financial planning (the Ten-Year Resource Allocation Plan, which includes projections over a 20-year time frame),
- Short-term allocation of resources (the two-year action budget),
- The Council Study Issues process,
- Performance "contracts" for Management, and
- Annual performance reporting and evaluation.

This integrated framework has enabled the City, over time, to accomplish the long-range strategic goals established by Council in the General Plan Elements and Sub-Elements. PAMS has assisted the City in maintaining, and even expanding, services during times of numerous Federal/State mandates and revenue restrictions or reductions. PAMS has also served as a valuable tool in producing and capturing remarkable gains in efficiency and productivity.

The Fiscal Sub-Element of the General Plan requires that the City Manager annually propose a budget that is balanced not only for the budget year, but also for the Ten-Year Resource Allocation Plan. Since FY 1993/1994, Council has approved a financial plan that has been balanced to the twentieth year. The long-term nature of the City's financial planning system allows decision-makers to better understand the true effect of policy decisions. Because City practice has been to prepare a fully balanced 20-year financial plan, it effectively requires that decisions made today guarantee that the resources will be available to provide quality services in the future. The Ten-Year Resource Allocation Plan prevents wild swings in service levels during the upturns and downturns of economic cycles.

Annual budget review and approval is a sound business practice and is required by the City Charter. However, an understanding of the City's long-term financial picture is more important to the process than just looking at a one-year or two-year snapshot. Therefore, much of the discussion in this Transmittal Letter will focus on long-term strategic planning and fiscal issues.

OPERATING BUDGET PROCESS

Sunnyvale has practiced two-year budgeting for our operating programs for a number of years. This is in recognition of the tremendous effort needed to develop budgets, particularly with the City's sophisticated outcome-based budget system. In normal times, service levels remain relatively constant from year to year. By doing two-year budgeting, staff time is maximized and more in-depth review of each budget element can be accomplished.

As indicated earlier, FY 2003/2004 is the second year of a two-year operating budget cycle. Therefore, operating budgets were not prepared. However, because of the budget reduction process discussed earlier, all programs were reviewed to identify potential service level reductions. Program managers developed four reduction packages, representing a 10% reduction and three 5% reductions. This information was reviewed by the City Manager, and used to develop the City Manager's recommended reductions to services and levels of service. These recommendations were presented to City Council on May 2, 2003, at which time Council provided preliminary policy guidance. This guidance was incorporated into the recommended FY 2003/2004 Budget and Ten-Year Resource Allocation Plan.

Further, as is our practice in the "off year" for operating, a number of other components of the operating budget were analyzed and updated to reflect current conditions. Rental rates and salary additive rates for the internal service programs were reviewed, with new rates applied to recover costs. Current salary levels for City employees were adjusted based on existing Memoranda of Understanding or estimated salary increases. For enterprise funds, significant cost components, such as purchased water, chemicals or landfill charges were updated with current information, and utility rates were adjusted as appropriate. Additionally, major revenue sources were updated for all funds.

PROJECT BUDGETING PROCESS

In the City of Sunnyvale the term "project" refers to non-operating activities. Beginning in FY 1999/2000, the City segregated each project into one of four possible categories: Capital, Special, Infrastructure and Outside Group Funding. These categories are defined as follows:

Capital Projects are major expenditures related to construction, improvement or acquisition of capital assets. This category includes feasibility studies, preliminary plans and other projects that are related to design, construction, capital improvement or acquisition. The construction of a traffic signal would be a capital project. Other examples include adding a room to an existing facility (capital improvement) or purchasing a piece of property (acquisition).

Special Projects are one-time only in nature and are set up to eliminate the impact that such costs would have on unit costs in operating programs. This category includes studies and other projects that are not related to construction, capital improvements, renovation/ replacement or acquisition of a capital asset. For example, the preparation of a new sub-element of the General Plan would be a special project.

Infrastructure Projects are inherently related to capital projects. This category includes the renovation and/or replacement of a capital asset. After a capital project is complete, the City has an asset that must be maintained through the operating budget until the asset reaches a point where maintenance costs exceed renovation/ replacement costs. An infrastructure project is developed in order to provide future funds at the time that replacement or renovation is required. An example would be the replacement of major components of the Water Pollution Control Plant or the replacement of the Heating, Ventilation and Air Conditioning (HVAC) system in City Hall.

Outside Group Funding Projects are essentially special projects; however, they are established to identify contributions made to local community-based organizations.

As mentioned earlier, the City's process for budget preparation places the project budget on a two-year cycle alternating with the operating budget. FY 2003/2004 is an "on year" for the project budget cycle.

The project budgeting process began in August as department directors and program managers started to review all existing projects and formulate any new projects that they felt were needed. As this process was underway, the City's severe financial situation became clearer, which required a change in focus.

In January, a 6-Point Action Plan in response to the budget crisis was presented at the Future Fiscal Issues Study Session. The report outlined strategies to address the City's fiscal problems. The first point of the 6-Point Action Plan called for staff to re-examine the Ten-Year Projects Budget and to make revisions that would help close the projected annual gap between revenues and expenditures. Departments were given four criteria to determine whether existing projects should be retained at current funding levels, retained at changed funding levels, or deleted from the Ten-Year Projects Budget. These same criteria were used in recommending new projects. The criteria are:

- Projects that preserved the integrity of the City's existing infrastructure systems
- Projects that addressed a life safety issue
- Projects that leveraged outside funding
- Projects that were currently under construction, were expected to be completed this fiscal year, or where suspending construction work now would jeopardize the integrity of the project.

The projects submitted by the departments then began the review process. All projects went through an initial review process conducted by Finance Department staff. This detailed review with project managers and department directors looked at every existing project and all new projects with the above criteria in mind.

Following the first review, the Project Review Committee began its work. As Council will recall, this Committee was created in FY 1999/2000 to evaluate and prioritize all project requests and make recommendations to the City Manager for approval. This Committee is staffed with members who are key to the project process, including the directors of Public Works, Community Development, Finance and Parks and Recreation. The Project Review Committee puts each new or changed project proposal through a rigorous evaluation process. Those new projects that have substantial and significant merit are forwarded to the City Manager for consideration in the recommended Budget and Ten-Year Resource Allocation Plan.

The Project Review Committee then considered each project in light of the four additional criteria discussed above. Based on those considerations, a total of 68 projects were not recommended for funding in the FY 2003/2004 Projects Budget. Of these, 40 are existing projects and 28 are new project proposals. A complete listing of all unfunded projects is included in a new section of *Volume II, Projects Budget.* This listing will be maintained and at such time as the City's financial position improves, they will re-evaluated for funding. The Committee did recommend 26 new project proposals for funding; more information on those projects is included below either in the *Major Project Efforts* section of this Transmittal Letter, in the *Detailed Fund Reviews,* or in *Volume II Projects Budget.*

As discussed earlier in this Transmittal Letter, the reevaluation of all projects included in the Ten-Year Resource Allocation Plan was conducted as part of the budget reduction process. The City Council adopted six criteria in March 2003 for reviewing recommended changes to the Ten-Year Projects Budget. Council considered the FY 2003/2004 recommended Ten-Year Projects Plan Report at a special meeting later in March 2003, and provided preliminary policy guidance. Based on this initial direction, changes to the Ten-Year Projects Budget will generate approximately $1.8 million annually towards reducing the gap between expenses and revenues in the General Fund.

OUTCOME-BASED BUDGETING

The City began to implement the outcome management system in FY 1995/1996 as part of a continuing effort to improve the City's Planning and Management System (PAMS). Since then, nearly all programs in the City's various funds have migrated to the outcome management system. A number of programs were delayed in their migration to outcome management in FY 2002/2003, given the staff resources required to develop the 6-Point Action Plan in responding to the City's budget crisis.

When designed in the mid-1990's, outcome management was created to address three purposes. They were:

- Identify high-level, fundamental results for each program included in the City's operating budget. Through this system, the focus would shift from the outputs generated by staff to the outcomes that are achieved by staff.
- Allocate scarce resources through the budget process so those program outcomes can be accomplished. Through this system, Council sets the high-level outcomes for each program, and staff determines how the outcomes can be achieved. Then Council sets budget allocations for each program.
- Report program performance annually, comparing the actual results achieved for programs with planned performance goals. Initially this was done annually through the Performance Outcome Agreement process, but now results for program outcome measures are reported more regularly.

This year, the City Council is requesting that staff undertake a comprehensive review of the outcome management system. This review will focus on the degree these original purposes are being met by the outcome management system. It will also identify any new purposes that the system should be redesigned to achieve. The review will also examine whether better use of information technology can lead to improve efficiencies and quicker turn around times in preparing performance reports and other "products" generated by the system. Finally, the review will address the training required so that program managers and other City employees can use the outcome management system as an effective tool in managing their programs. Current manuals and training programs will need to be updated by City staff so that new managers can learn how to use the system, and existing staff can brush up on their skills.

The outcome management system is an important component of PAMS. As such this review will begin a systematic assessment of PAMS. Additional opportunities will be identified to update and improve PAMS. This effort will also examine existing training and resources that need to be updated so that this vital system remains an effective planning and management tool.

BUDGET FORMAT AND AWARDS

Sunnyvale has an extremely complex and detailed budget preparation, review and adoption process. Staff has traditionally presented to Council the City Manager's recommended Budget in the form of a workbook. This workbook is used to guide the Council through the budget workshop, the public hearing and finally the official adoption of the budget for the upcoming fiscal year.

The recommended Budget document is divided into four stand-alone volumes this year. *Volume I* includes documents that staff provides to Council on an annual basis. The *City Manager's Transmittal Letter*, *Budget Summary*, *Long-Term Financial Plans*, *Revenues***,** and *User Fees* can be found in this volume. *Volume I* is useful as a summary document, with more detailed information found in the other three volumes.

Volume II Projects Budget contains all of the City's capital, infrastructure, special and outside group funding efforts. This volume begins with a *Projects Budget Guide* that describes what a project is in the City of Sunnyvale and how projects are prioritized in the budget process. This volume receives detailed attention during the "on year" for projects, which is FY 2003/2004.

Volume III Operating Budget contains all of the City's programmatic efforts. This volume also begins with an *Operating Budget Guide* that describes Sunnyvale's unique Planning and Management System. This guide is extremely useful in understanding the mechanics of the City's efforts to move from performance-based to outcome-based budgeting. The Operating Budget is organized around the seven elements of the General Plan. Each element contains the General Plan's Goals, Policies and Action Statements, Community Condition Indicators, and the budget of each operating program that is tied to that particular element. This volume receives detailed attention during the "on year" for operating, as was the case for FY 2002/2003.

Volume IV, Recommended Reductions, contains the 6-Point Action Plan and four special reports to the City Council. The four special reports consist of:

- Review of the City's 10-Year Capital Projects Plan
- Points 2 and 4 of the City Manager's 6-Point Action Plan in Response to the City's Fiscal and Budget Crisis: In-Lieu Fees/Inter-Fund Transfers
- Recommended Reductions to City Services and Levels of Service Report
- Potential Fee, Charge and Tax Increases

In addition, there are two companion reports and several related attachments that outline proposed criteria for evaluating reductions to capital projects and city services, and one report regarding the formation of an ad hoc advisory committee to study potential tax increases.

In prior years staff has received positive feedback from Council members and citizens regarding the Budget-in-Brief booklet. This is an effort to highlight the important aspects of the particularly large and complex recommended budget document. This year, staff will again prepare this summary containing the City Manager's Transmittal Letter and Budget Summary.

In April 2003 the Department of Finance was notified that the City's adopted FY 2002/2003 Budget and Ten-Year Resource Allocation Plan had received the Distinguished Budget Presentation Award from the Government Finance Officers Association (GFOA), a national organization of finance professionals. This award program, established in 1984, "recognizes exemplary budget documentation by state, provincial and local government, as well as public universities and colleges." The City of Sunnyvale has received this award for 14 consecutive years.

FISCAL YEAR 2003/2004 BUDGET

OVERVIEW

I am once again presenting a balanced budget for this upcoming fiscal year. The Ten-Year Resource Allocation Plan and 20-year financial plan are in balance as well. As discussed earlier, the recommended FY 2003/2004 Budget contains a number of reductions to service and service levels or increases to revenues that were made in response to the City's current fiscal crisis.

Table I, below, is a summary of the recommended expenditures for all City funds. This table provides a comparison of the recommended FY 2003/2004 Budget with the current fiscal year and the latest actual fiscal year.

*Table I Recommended Expenditures – Citywide**				
Expenditure Character	2001/2002 Actual	2002/2003 Revised Budget	2003/2004 Recommended Budget	% Growth 2003/2004 over 2002/2003
Operating	145,154,918	156,448,303	168,245,562	
Recommended Operating Reductions			(8,968,471)	
Recommended Rental Rate Reductions			(1,499,562)	
SMaRT Station Operations**	10,901,599	10,078,158	9,511,077	-5.63%
Operating Sub-Total	156,056,517	166,526,461	167,288,606	0.46%
Projects	33,682,267	97,715,023	19,675,844	
Recommended Project Reductions		(8,677,650)		
Projects Sub-Total	33,682,267	89,037,373	19,675,844	-77.90%
Debt	6,973,449	5,226,271	6,978,123	33.52%
Lease Payments	1,218,753	1,215,678	1,216,678	0.08%
Equipment	282	300,000	0	-100.00%
SUB-TOTAL	197,931,268	262,305,783	195,159,251	-25.60%
Employment Development Grant Programs	11,572,804	12,454,155	12,430,000	-0.19%
TOTAL	**209,504,072**	**274,759,938**	**207,589,251**	**-24.45%**

* This table excludes internal service fund expenditures.

** SMaRT Station Expenses represent Mountain View and Palo Alto's shares of SMaRT Station expenses. Sunnyvale's share of expenses is represented in the Operating line.

The overall recommended FY 2003/2004 Budget is 24.45% below the adopted FY 2002/2003 Budget. However, the inclusion of the Employment Development Grant programs and project-related expenditures can be misleading when making year-to-year comparisons.

The recommended FY 2003/2004 Budget for operating-related expenditures is .46% higher than the Revised FY 2002/2003 Budget. These figures include almost

$9 million in operating reductions and $1.5 million in rental rate savings. In normal times, the budget would have increased by 7.5% due primarily to increases in the cost of salaries and benefits. This year these costs were offset by the reductions mentioned above. This issue will be discussed in more detail in the *General Fund* section of the *Detailed Fund Reviews* and in the *Employee Benefits Fund* review.

As you may note, the project line item has seen a dramatic decrease from FY 2001/2002 Actual and FY 2002/2003 Revised Budget to the recommended FY 2003/2004 Budget. Although this type of yearly comparison is difficult to make because of the one-time nature of projects, the substantial reduction is due to the elimination of a number of projects due to the City's budget crisis.

Additionally, in the prior year, the City had a number of large projects funded from outside organizations or debt financing. Examples of these projects are the Multimodal Transit Station, construction of the new Senior Center, and various Wastewater infrastructure projects funded by a Wastewater Revenue Bond. Several important capital projects have been completed during FY 2002/2003. These will be discussed in the *Major Projects Efforts* section of this Transmittal Letter.

Because of the appropriation pattern for projects discussed above, project funds are often carried over from year to year. This can be seen in the FY 2002/2003 Revised Budget number of $89 million for projects. Of this amount, approximately $31 million represents carryover of funds for projects in progress from FY 2001/2002.

Below are listed some of the largest project efforts that make up the $20,213,310 in the recommended FY 2003/2004 Budget. Please note that some of these projects are multi-year and the dollar amounts represented are only the FY 2003/2004 appropriations.

- Borregas Sanitary Trunk Sewer Replacement ($2.6 million) – Wastewater Fund
- Civic Center Buildings HVAC ($1.2 million) – Infrastructure Fund
- Storm Pump Station No. 1 Rehabilitation ($1.2 million) – Wastewater Bonds
- Water/Sewer Supervisory Control System ($1.1 million) -Water Fund
- Public Safety Building HVAC ($1 million) – Infrastructure Fund

As Council can see, it is important to understand that the City's budget is comprised of multiple budgets or funds, with the real short-term and long-term position of the City contained in the respective position of each of these funds. This Transmittal Letter will discuss each fund in detail, but places emphasis on the General Fund.

Finally, any long-range financial or strategic plan must make certain assumptions in establishing the basis for projections. The next section discusses the assumptions that staff has developed for this particular recommended Ten-Year Resource Allocation Plan and its accompanying 20-year financial plan.

BUDGETARY INFLATION FACTOR

Inflation of budgeted costs for the recommended Ten-Year Resource Allocation Plan and 20-year financial plan is assumed to be unchanged at 3% per year for the first ten years, and 4% for the second ten years. Certain selected budget components, such as purchased water, gasoline, or electricity are increased according to their individual cost characteristics. Salary projections are based on current memoranda of understanding ("MOU"s) with employee associations. Beyond the MOUs, assumptions for employees represented by the Public Safety Officers Association ("PSOA") are that salaries will increase by 5% for FY 2004/2005, 3% through FY 2008/2009, and then 4% thereafter. For all other employees, it is projected that salaries will increase by the budgetary inflation factor.

Projections for major revenues are based on detailed analyses of their unique characteristics and therefore they do not necessarily reflect a simple inflation pattern. The assumptions for each major revenue source will be detailed in the discussions of each appropriate fund.

The budgetary inflation factor is a critical assumption and has the following long-term consequences:

- The City's financial position is improved overall when inflation is low. This is because, in general, the City's major revenue sources grow at a rate slower than inflation over time, while expenses grow at inflation or greater. Should inflation occur at a higher rate than projected, the financial plan would be negatively affected.

- Expenditure growth has to be limited to the growth of inflation, or the projections in the financial plan will not hold. The most significant portion of the operating budget is labor costs. This amounts to 64% of the Citywide annual budget and 77% of the annual General Fund budget. The extremely low unemployment rate that our area enjoyed during the economic boom has resulted in recent salary and benefit increases for our employees that have been substantially higher than inflation. Our budgetary assumptions have incorporated the projected increases to above market for our employee associations. If labor costs increase in the future substantially beyond these assumptions, the long-term expenditure projections may be understated.

FUTURE FISCAL ISSUES

Each year in January a Council Study Session is held that identifies factors in the City's current environment and in the near-term that could impact our fiscal security. This year, the Study Session was held to further outline and clarify a significant ongoing structural imbalance between revenues and expenditures in the City's General Fund that was identified in the previous fiscal year. This structural imbalance is the result of two converging factors. First, a deep and continuing economic downturn, especially in the Silicon Valley area, has substantially reduced our revenue base. Second, employee costs, including base wages and retirement costs, continue to sharply increase. A third factor, the State budget situation, poses a continued threat to our revenues that could further negatively impact our fiscal position.

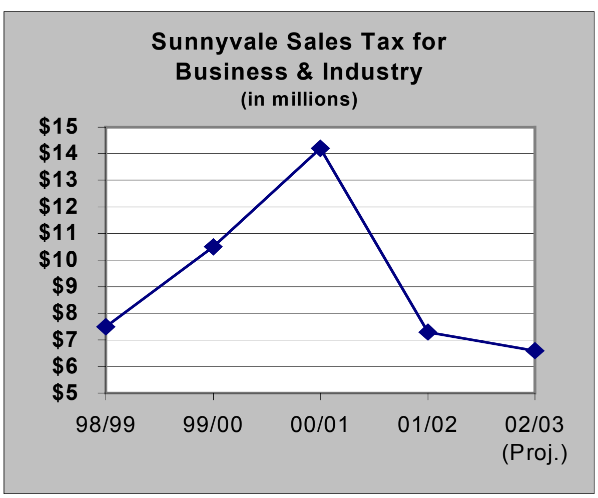
CURRENT ECONOMIC CONDITIONS AND OUTLOOK

Just three years ago, the nation was in the longest economic expansion in U.S. history. The Silicon Valley was booming and Sunnyvale's finances were buoyed by significant increases in General Fund revenues. Since that time a number of events have occurred nationally and locally that have dramatically altered our financial position.

On a national basis, the U.S. economy decelerated sharply beginning in late 2000 after experiencing nearly ten years of sustained economic growth. Gross domestic product (GDP) growth slowed from over 5% in the first half of 2000 to 1.4% by the fourth quarter of the year. After September 11th the downturn intensified. Especially significant for Sunnyvale and Silicon Valley was the dot.com bust and resulting spillover effects of reduced business expenditure on computer hardware and software. This condition continues to persist in 2003.

Since the economic downturn began, the Silicon Valley has lost nearly 200,000 jobs. To better put this into perspective, one noted California economist has said that if measured in terms of job loss, what we are experiencing here is on par with losses suffered during the Great Depression. After falling to record lows of around 1.3% in 2000, unemployment in Silicon Valley stands at 8.3% versus 6% nationwide. Some areas in the Valley currently are experiencing unemployment rates higher than 10%. Due to the tech-heavy concentration in our region, unemployment will likely remain higher here than the rest of the country for the near future, further slowing the pace of an economic turnaround.

Effect on Sunnyvale Revenues



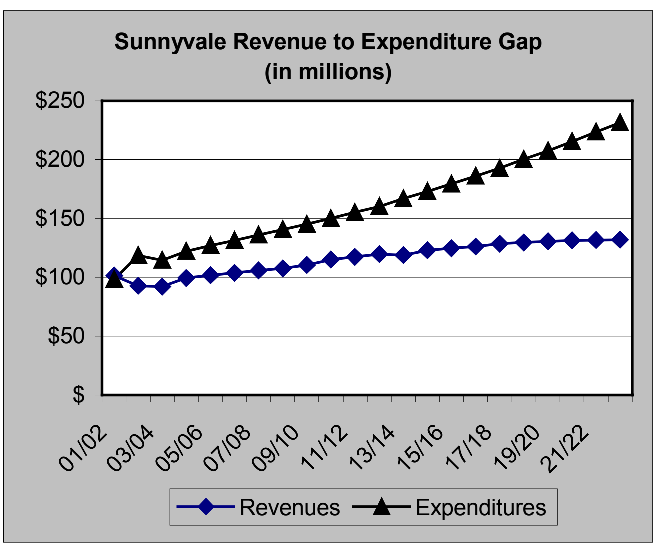
One result for Sunnyvale has been a decline in General Fund revenues, fueled by sharp drops in Sales Tax and Transient Occupancy Tax (TOT) receipts. By the end of FY 2001/2002 Sales Tax and TOT revenues dropped by 30% and 40% respectively from the records highs of FY 2000/2001. Initially, revenue projections for these and other revenue sources were anticipated to level out in FY 2002/2003, but it appears this will not be the case. For example, TOT is expected to be 23% lower than projections, while construction-related revenue is projected to be 20% lower than budgeted. Sales Tax revenues are trending to be 11% lower than expected. Overall, we expect to receive $3.8 million, or 7% less, in revenues than expected in FY 2002/2003.

Projected Pace of Recovery

The basis for a projected pace of recovery begins with the premise that the intensity of the Silicon Valley technology boom in 2000 was in all likelihood an anomaly that may not ever be repeated. As the graph on the left illustrates, Sunnyvale Sales Tax in the Business and Industry sector spiked by nearly 90% from FY 1998/1999 to FY 2000/2001, before sharply returning to early 1998 levels in FY 2001/2002. This sector will sustain further losses in FY 2002/2003, with revenue projections dropping below $7 million for the first time since FY 1990/1991. Not coincidentally, this sharp spike parallels the huge increase and subsequent drop in State General Fund revenues that was largely fueled by capital gains and stock options.

The one consistent theme from economists is that a recovery here and across the nation will be modest and slow, a theme that is echoed in our own forecasts over the Long-Term Financial Plan. Unemployment in the region remains high, but there are positive signs in the form of modest gains in earnings reports and projected increases in sales from select technology companies. Due to the tech-heavy emphasis in our region and the resulting losses in jobs, productivity and sales, the recovery here is significantly lagging the state and the rest of the country. While many other areas in California are experiencing a modest growth in Sales Tax and other revenues, Silicon Valley has not yet seen an upturn. Further, the record budget deficit at the State level will have negative effects on the State's economy in terms of reduction in employment and spending that may slow the recovery even more.

ONGOING STRUCTURAL DEFICIT



The continued decline in Sunnyvale's General Fund revenues and the sharp rise in personnel costs have led to an ongoing structural imbalance of revenues to expenditures in the City's General Fund. This gap is now estimated to be $14-15 million annually. Over a twenty-year period, the gap will continue to widen considerably without corrective action, as the graph below depicts. The City Manager has outlined a 6-Point Action Plan to reduce the gap through a combination of service level and expenditure reductions and potential revenue enhancements. City staff has identified approximately $13.4 million in service level and other reductions, but a portion of this amount is comprised of purchased goods and services and non-full-time employee costs. For the foreseeable future, permanent employee costs will likely grow faster than available revenues needed to fund such expenses. To the extent rising employee costs continue to outstrip revenue growth, the $14-15 million revenue to expense gap will continue to grow.

During the previous operating budget cycle, City staff anticipated sharp increases in the areas of worker's compensation and medical insurance for FY 2002/2003 and beyond. At the same time, staff also projected increases that were several percentage points above inflation for retirement costs and base wages (for the SEA bargaining unit). These estimates proved to be too low, as the City's retirement provider, CalPERS, continues to suffer unprecedented market losses that we must make up in the form of higher employer contribution rates. This is compounded by a significant difference between base wage projections by CalPERS (3.75%) and actual increases (9%).

Base wages have increased over and above projections due to a variety of factors. In accordance with the City's competitive compensation philosophy, adjustments had been made in recent years to move base wages to an above average position. However, due to the continued high cost of living in the Bay Area, the upward movement in the market requires additional increases to maintain the City's position. Furthermore, the current wage formula for the SEA bargaining unit calls for movement to 2% above the average by FY 2003/2004. Additionally, the market has been impacted by the same factors discussed here and particularly in medical insurance costs, which are included in the total compensation wage calculation.

STATE BUDGET SITUATION

Less than three years ago, the State government was anticipating a budget surplus of up to $13 billion. In a stunning reversal of fortune, the State now forecasts an unprecedented $35 billion deficit (or more) by the end of FY 2003/2004. This leads to the question: Where did all the money from the good times go? There are three main answers to this. First, State revenues sharply declined, largely due to decreases in personal income tax from capital gains and stock options. Second, as State revenues were growing throughout the 1990s, so were expenditures. From FY 1993/1994 to FY 2000/2001, State spending more than doubled, from $39 billion to $79 billion. The third reason lies in unplanned expenses, chiefly the fact that the State did not anticipate well, or recover well, from costs related to the energy crisis of 2000. The result of these converging factors is that the State has a significant ongoing structural deficit that will not disappear without corrective action.

To date the Governor has proposed balancing the budget with a combination of spending reductions (including reductions in ongoing funding for local governments in the form of State "shared" revenues), borrowing, and tax increases. However, Republican legislators have vowed to fight <u>any</u> potential tax increases. One of the Governor's proposed reductions would eliminate the Vehicle License Fee (VLF) backfill. The VLF is a Constitutionally guaranteed local revenue source, a major portion of which is "back-filled" to cities after it was legislatively reduced in the 1990s. Elimination of the backfill would mean an annual revenue loss of nearly $5 million to Sunnyvale. The VLF was reduced by the Legislature with the proviso that if the State could no longer afford the backfill, then a "trigger" would be pulled to restore the VLF to previous levels. After legal review in late 2002, the Democratic administration concluded that the State's Finance Director could "pull the trigger" without invoking the voter approval requirements of Proposition 218. It is anticipated that the State will move in the near future to pull the trigger and restore the VLF to its full level, saving the State several billion dollars and guaranteeing that local governments will receive full funding from this revenue source. However, the Republican Caucus has vowed to challenge this, either in court or by supporting a ballot initiative to invalidate the VLF restoration.

Current budget proposals from both houses of the Legislature call for a minimum of $250 million in "unspecified reductions in State-shared revenues for cities." One other unresolved issue is whether to shift property taxes from local redevelopment agencies, similar to the ongoing ERAF shifts implemented in the early to mid 1990s.

By the end of this fiscal year, the State's revenues are projected to be $361 million *below* projections, while expenditures are estimated to be $2.7 billion *more* than anticipated, which will likely add to the record budget deficit. While State officials have recently agreed upon $3.7 billion in spending cuts (none of which affect local governments), this number represents only a fraction of what is needed to close the State's budget gap.

There are further ominous signs that the State's budget woes are getting worse, which will ultimately mean deeper ongoing cuts to local governments. In early May 2003 the State Controller again announced, as he did last year, that the State will deplete its cash reserves this June and will have to borrow money from private lenders to meet its financial obligations. The State will seek the maximum allowable amount of $11 billion in Revenue Anticipation Warrants (RAW) in order to pay its statutorily required bills. This amount is nearly 47% more than the RAW needed last year and marks only the sixth time the State has employed this borrowing instrument since 1939. Further, State lawmakers plan to issue nearly $2 billion in Pension Obligations Bonds to pay for escalating employee pension contributions for the current and following fiscal years, and repay the amount plus interest over five years. Still other Republican proposals call for borrowing billions more in bond issues backed by existing sales tax revenues and *anticipated* tobacco settlement money.

California plans to borrow some $30 billion over the next year in short-term loans to cover operating expenses, long-term general obligation bonds approved by voters and other borrowing, which has led to warnings from several prominent Wall Street Investment Firms. These firms have underscored the risks involved with such large-scale borrowing and have further warned that such financing techniques should only be carried out in conjunction with tax increases.

A better picture of the Governor's deficit reduction strategy will be available after his revised budget is released on May 14, 2003. As with the prior year, early indications point to a protracted budget stalemate in the Legislature, especially given the enormity of the State's budget situation.

FISCAL STRATEGIES

One of the most powerful aspects of multi-year budgeting and projection is the ability to plan for the future. Small changes now can avert large problems later. When the issues identified in the previous section are viewed in their totality, and the financial condition of each fund is reviewed carefully, it is clear that there is little room for significant service expansion without revenue enhancement.

In previous Transmittal Letters I have outlined a number of key strategies to help us deal with future financial realities. These strategies have worked over the years to maintain our fiscal stability and allow us to continue providing high quality services. In light of the current budget crisis, these strategies will be particularly important in allowing us to provide the best possible customer service to our citizens within the resources available.

- **Emphasize economic development**

  A strong, City-led economic development effort is required in these difficult economic times to reduce unemployment and to increase City revenues.

  The Downtown Redevelopment Program is a key element in our economic development strategy. We need to build consensus around the new Downtown Design Plan, support Mozart Development in finding strong tenants for the two unoccupied new buildings, and negotiate a partnership with new owners of Town Center Mall for revitalization and expansion in accordance with the Downtown Design Plan. The Mall must be turned around this year, not only to support the City's sagging retail sales tax, but also to instill confidence among other Downtown businesses, property owners and developers, so that they will move ahead with their redevelopment and reinvestment plans.

  Sunnyvale has developed a reputation as a business-friendly community. We must reinforce this well-earned reputation in the coming year. We have been careful in our budget cuts to not negatively affect the timeliness and helpfulness of our development services program. The Mayor has begun a series of visitations to major employers, major sales tax generators and promising start-up industries. Our economic development staff serves as ombudsmen for business within City Hall. A satisfied existing Sunnyvale business is our best marketing tool for attracting new business.

  Last year we launched a marketing campaign directed internally to the Sunnyvale community. It emphasized the importance of business to the community, pointing out that approximately 70 percent of City revenues are derived from business. Next year our marketing program will be more externally directed. A strategic marketing effort will tout Sunnyvale's advantages to expanding regional firms in bio-, nano-, info- and wireless technologies. It will be a collaborative strategic marketing effort, involving local businesses and commercial brokers, and coordinating with other regional marketing programs.

- **Use cost-effective technologies to increase productivity, enhance customer service and/or reduce the cost of service**

  Technology is a critical tool in supporting the delivery of high-quality services to our citizens. It has always been the City's practice to carefully review and scrutinize information technology projects in a manner that allows us to yield the highest return on our investment. This strategy will be increasingly important as we move toward working within the City's new fiscal reality. Effective applications of technology can simplify work procedures and improve efficiencies, enhancing productivity and quality of services across the entire organization.

The City has a very solid track record of success in developing and deploying an information technology strategy that supports the needs of the community in a realistic and reasonable manner. However, the City does not operate in a static environment. As discussed earlier, recent changes in the City's fiscal environment will affect how we approach the use of information technology.

Last year, the Information Technology Director embarked on a major effort to update the City's Information Technology Strategic Plan. The plan is in final draft form and includes a strategy for implementing E-Government solutions to assist City departments in meeting increased service requirements while improving City interaction and communication with constituents. As a result of the budget crisis, the Information Technology Director will finalize the Information Technology Strategic Plan after the full implications of the budget reductions are known. It is likely that the plan will require some major modifications in order to realistically align with available resources.

- **Pay close attention to the financial impact of policy decisions made throughout the year**

  Many of the study issues initiated by Council each year can have significant long-term financial implications. Although the budget is reviewed only one time each year, decisions that affect it are made throughout the year. Unfortunately, when such decisions are made outside of the annual review of the budget, it is more likely that the long-range financial picture for the City will not receive the attention due. Further, when potential new expenditure items are reviewed independently, it is virtually impossible to put them in a context of other competing expenditure requirements. The City has entered a period of diminished economic resources, and great restraint will be required as we strive to redefine our services, levels of service, and optimum workforce.

- **Rely on multi-year financial planning for key decisions**

  Continue to place emphasis on performance-based/ results-oriented budgeting, as well as strategically analyze issues from both an immediate and long-term perspective. The strength and power of Sunnyvale's long-term financial planning systems have helped us to weather previous financial downturns and has given the City a strong foundation to address our current budget crisis. Our outcome budget system allows Council to set service levels in response to needs expressed by residents, businesses, and community groups. In difficult financial times like these, the outcome management system also allows Council to reset service levels to align with reduced revenues. Of course, the principal power of the entire planning and financial management system is its ability to identify financial trends in the future. This allows us to take orderly steps to address problems that other cities and counties may not yet have even identified. Additionally, the practice of multi-year forecasting allows the City to "live at the trend line" and not spend one-time resources on unsustainable recurring services. These systems are invaluable resources that staff relies on in these uncertain fiscal times.

MAJOR PROJECT EFFORTS

Sunnyvale's projects budget is a complex document involving four separate and distinct categories of projects: capital, infrastructure, special, and outside group funding. The projects themselves are budgeted and accounted for in various funds, most notably the General and Gas Tax Funds, the Capital Projects and Infrastructure Funds, and the Utility Funds.

Major initiatives and actions have added to this complexity. For example, the City's remarkable infrastructure planning and funding efforts led to the creation of long-term projects to fund major renovation and replacement efforts. The City's debt financing strategies are also reflected in this area.

Additionally, the past few years have seen a marked increase in various grants and special funding sources available for specific project categories, such as parks and streets and transportation. These revenue streams include the Santa Clara County half-cent sales tax for transportation (Measure B), traffic mitigation fees, State park grants (Proposition 12 and Proposition 40), park dedication fees, and new monies for the Traffic Congestion Relief program (AB 2928 and Proposition 42).

Five major new projects were completed or substantially completed during FY 2002/2003. These are: the Fremont Pool, which opened in Spring 2002, the underground parking structure in Downtown Sunnyvale which opened in July 2002, the Multimodal Transit Center and the Fair Oaks Skateboard Park, both of which opened in May 2003 and the Senior Center, which will open in early July 2003. The completion of these facilities represents a significant accomplishment for the City.

The recommended FY 2003/2004 Budget includes funding for a total of 338 projects in all categories over the Ten-Year Plan. This section discusses some of the special funding sources and provides information on major project initiatives. Descriptions of other projects are included in the *Detailed Fund Review* section of this Transmittal Letter.

SPECIAL PARKS FUNDING

<u>**Proposition 12 Funds**</u>

The passage of the Safe Neighborhood Parks, Clean Water, Clean Air and Coastal Protection Bond Act of 2000 (Proposition 12) means Sunnyvale will receive more than $1.5 million in new funds for parks over the next few years. These funds, which are allocated to cities on a per capita basis, may be used to pay for acquisition, development, improvement, rehabilitation, restoration, enhancement and interpretation of local park and recreation lands and facilities. In FY 2001/2002 and FY 2002/2003 Sunnyvale programmed $1.3 million of these funds for a variety of park improvements. Approximately $250,000 remains to be allocated. These funds will be programmed in next year's two-year projects budget, pending the results of actual costs of those projects listed above.

Proposition 40 Funds

The passage of a second bond measure under the California Clean Water, Clean Air, Safe Neighborhood Parks and Coastal Protection Act of 2002 (Proposition 40) will provide the City with an additional $1 million for park and open space projects in Fiscal Year 2003/2004 assuming the Governor's budget passes. Staff is proposing that $500,000 of these monies be the City's contribution toward the creation of an historical museum to be constructed at Orchard Heritage Park in partnership with the Sunnyvale Historical Society and Museum Association. It is anticipated that the remainder of these monies would be used to supplement funding for the Downtown Plaza Park.

Park Dedication Funds

When developers of multi-family housing do not dedicate land for use as parks, the City collects a fee in lieu of the land dedication. These park dedication fees are then used to pay for park facilities. These fees helped to pay for the Fair Oaks Skateboard Park and will help to fund a variety of upcoming projects, including:

- The Downtown Plaza Park at Evelyn Avenue and Frances Street, and
- Improvements to the playground at Ortega Park.

TRAFFIC AND TRANSPORTATION FUNDING

Santa Clara County Measure B Pavement Management Program

In November 1996 Santa Clara County voters approved Measures A and B. These measures provided for a new general Sales Tax within our county, with proceeds earmarked specifically for transportation improvements. Following an unsuccessful legal challenge by taxpayer groups, the County Board of Supervisors and the Valley Transportation Authority (VTA) established procedures for the allocation of funds in 1999. The City of Sunnyvale has been allocated approximately $7.7 million over a five-year period for pavement management-related capital projects from Measure B funds.

All Measure B funds have been appropriated through FY 2002/2003. Work on a number of these projects is currently underway, with completion scheduled for FY 2003/2004. A small amount attributable to interest earnings remains in this fund for future appropriation.

State Traffic Congestion Relief Program (AB 2928) and Proposition 42

The State Traffic Congestion Relief Program (AB 2928) was part of the budget trailer bill for the transportation finance package of the State's FY 2000/2001 Budget. As part of this finance package, approximately $1 billion from the State portion of Sales Tax on gasoline sales will go directly to cities and counties for preservation, maintenance and rehabilitation of local street and road systems for the period FY 2000/2001 through FY 2005/2006. These new funds are allocated on a per capita formula. AB 2928 funds impose a maintenance of effort requirement that obligates the City to maintain a level of expenditures for street, road, and highway purposes equivalent to the average expenditures for FY 1996/1997, FY 1997/1998 and FY 1998/1999. In addition, a "use it or lose it" provision requires that the City expend these funds by June 30th of the fiscal year following the one in which they were received. The legislation also requires that the monies be held and accounted for in the City's Gas Tax Fund.

When the legislation was first passed, it was projected that the City would receive approximately $3 million under AB 2928. In October 2000 the City received funds in the amount of $949,530 representing the first disbursement of AB 2928 monies for FY 2000/2001. AB 2928 funds in the amount of $338,586 were received in FY 2001/2002 and $378,419 is estimated for FY 2002/2003. This leaves funds in the amount of about $1.5 million unappropriated.

Due to the current State budget crisis, the remaining funds in this program are in jeopardy. Early budget proposals indicated that the monies would be defunded. Since the status of AB 2928 funds is currently unknown, no further appropriations have been made in the recommended FY 2003/2004 Budget. Should any of these funds become available, staff will program them in future years.

In March 2002, a constitutional amendment that permanently shifts the sales tax on gasoline from the State General Fund to the Transportation Investment Fund created by AB 2928 was approved by the voters as Proposition 42. The effect of this action was to indefinitely extend the allocation of Traffic Congestion Relief Program funds to cities, counties, and transit agencies beginning in FY 2008/2009. Preliminary information indicated at the time of passage that Sunnyvale's annual allocation would be approximately $1.2 million. In the meantime, the State budget crisis has put these funds into question. The potential exists for Proposition 42 funds to be diverted from the originally intended recipients to other transportation priorities. City staff are closely monitoring the discussions and working to ensure that at least a portion of these funds will be available for the City's transportation needs. However, because of the uncertainty, these funds have not been programmed in the recommended FY 2003/2004 Budget.

Traffic Mitigation Funding

The Public Works Department is currently in the process of completing a Transportation Strategic Program as part of the Revenue Sources for Major Transportation Capital Improvement Projects Study Issue. The Transportation Strategic Program will be used to identify potential revenue sources for major transportation necessary to support the City's land use plans.

The cost of this mitigation is considerable, estimated several years ago in the Land Use and Transportation Element in excess of $100 million. This level of funding cannot be accommodated by the City's current Resource Allocation Plan. In order to provide for planned, orderly development in Sunnyvale over the next 20 years, an interim funding mechanism has been implemented for transportation improvements. This revenue source, known as Cumulative Traffic Mitigation, will mitigate cumulative impacts of the Land Use and Transportation Element of the General Plan, and offset the potential revenue loss that would result if the City waited until the Transportation Strategic Program is completed before implementing a fee or assessment. It is anticipated that when the Transportation Strategic Program is completed and presented to Council, the interim Cumulative Traffic Mitigation would be revised.

The adopted FY 2002/2003 Budget included projects funded from Cumulative Traffic Mitigation revenues. The recommended FY 2003/2004 budget includes no new projects for the upcoming year. Since these mitigation measures are not yet finalized or identified in the current capital program, these funds will be appropriated over the next several years as the projects are developed.

INFRASTRUCTURE RENOVATION AND REPLACEMENT

Sunnyvale has traditionally provided funding in its operating budgets for optimizing maintenance of City infrastructure. Staff believes this to be the most cost-effective, long-term way to approach asset management.

Nonetheless, even with this proactive maintenance approach, eventually every infrastructure element reaches a point where maintenance is no longer a cost-effective strategy, and significant renovation and replacement is required. Planning for infrastructure requirements is no small undertaking. There are two reasons for the magnitude of the challenge. First, much of the infrastructure maintained by the City was never initially a cost to us. Most of the roads, streetlights, and utility lines were paid for by owners of the benefiting, adjacent properties at the time various areas of the City were developed. When major renovation or replacement is needed, however, this same source of revenue support is no longer available. Second, even during the time when local governments in California had considerable flexibility with revenue sources, the likelihood of gaining constituent support for tax increases or assessments for this purpose was not high. In today’s far more constrained revenue raising environment, it becomes even more difficult.

Although funding of the renovation and replacement of the City’s estimated $1 billion in infrastructure assets is an enormous challenge, it is also critical to the long-term quality of life and financial condition of the City. Because of this fact, the City has undertaken an unprecedented effort to plan for this eventuality with a comprehensive Long-Range Infrastructure Plan (LRIP).

The development of this plan was split into two distinct phases. The City completed Phase I of the LRIP by establishing the Infrastructure Renovation and Replacement Fund and incorporating full funding for the General/Gas Tax and Community Recreation Fund assets.

Phase II of the LRIP addresses fixed assets within the utility funds (Water, Wastewater, and Solid Waste). Staff has been identifying and inventorying utility-related fixed assets, and providing preliminary estimates for replacement costs and lifespans. Because the Solid Waste Management Fund contains only a few assets, staff was able to complete a financing plan for those assets in the current rate structure for solid waste fees. However, the Water and Wastewater Funds have a large number of varied assets, including water mains, water valves, reservoirs, sewer collection equipment, storm drains and the Water Pollution Control Plant to name only a few. Assumptions for how much the replacement of these assets will cost and when replacement will occur are essential to forming choices for financing strategies.

In order to provide more realistic estimates, staff has been collecting data on how these fixed assets perform in varied conditions. The City's utility maintenance management database effort (Maximo) began several years ago for this purpose. The resulting work product was to be incorporated into the Maximo database. Work proceeded slowly while assessment of Maximo and exploring implementation options with City systems progressed.

At the time of this writing, funding for the purchase, installation, set-up, ongoing maintenance and operation of Maximo is recommended for removal from the City's Capital Improvement Program. This reduction in resources will slow the full establishment and implementation of the LRIP. In the future, emphasis will be on maintenance of the system, and complete documentation of ongoing work as it is performed. Incorporation of historical data will be accomplished when possible. This limits the effectiveness of the LRIP, which will improve as more information becomes available.

The increased political attention to infrastructure will likely mean the development of intergovernmental programs that provide assistance in the areas of rehabilitation and replacement. This assistance could include low-interest loans from "infrastructure banks," matching programs, and/or grant funding. Any financial assistance will help defray the effect of future infrastructure costs on our ratepayers.

MATHILDA AVENUE RAILROAD OVERPASS REPLACEMENT AND RECONFIGURATION

The State of California Department of Transportation (Caltrans) inspects bridges throughout the state every other year for structural adequacy and functional operation. They have been doing this bi-annual inspection for many years and the reports are given to the City to address any corrective action that is documented. These reports are used as the basis for the City's maintenance efforts on bridges and included as part of the overall infrastructure management program.

As per the latest Caltrans inspection report, the current Mathilda Avenue Railroad Overpass bridge design does not meet bridge pier clearance standards, deceleration lane design standards, shoulder width standards, and bridge railing standards. These deficiencies create potential hazards to the public, and present a potential liability issue for the City.

City staff has successfully secured federal funds with 20% local match for removing the deficiencies and improving traffic circulation on the bridge. The proposed bridge improvements include reconfiguring the off ramp to Evelyn Avenue to allow full access to Evelyn from southbound Mathilda Avenue. As an added benefit, this improvement can service the anticipated increase in traffic from southbound Mathilda Avenue to downtown Sunnyvale.

A conceptual layout of the improvement proposal with a preliminary cost estimate of $17.42 million for the project has been submitted to Caltrans for funding purposes. The requirement of 20% local match translates to a maximum federal share of $13.93 million with the City's share of $3.48 million. However, Caltrans has indicated to City staff that a limit of $10 million of Federal Hazardous Bridge Rehabilitation Replacement funding is placed on this project at this time. This would require the City to commit to a match of $7.42 million. Caltrans has also indicated to City staff that increased funding requests are considered on a case by case basis. City staff is continuing to work with Caltrans to increase funding. An alternative has also been prepared by refining the proposed improvements, which reduces the project cost to $14.4 million. The 80% of the reduced cost still exceed the federal contribution of $10 million. Caltrans has given direction that design should proceed prior to applying for increased funding. The current schedule calls for design to be completed in March 2005, and submittal of the high cost project application in June 2005.

The recommended FY 2003/2004 Budget includes the Mathilda Avenue Railroad Overpass project unchanged at the $17.5 million project cost. As design work and negotiations with Caltrans continue, this project estimate will be modified to reflect the actual funding level and funding sources. As indicated above, additional City funds may be needed to fully construct this project.

DOWNTOWN PLAZA PARK

The Downtown Plaza Park will be under construction during FY 2003/2004. Staff has reviewed alternative design concepts with residents, boards and commissions, and the City Council. Construction drawings are now being prepared for the concept preferred by most parties. It will be a unique open space resource for Sunnyvale, designed to accommodate gatherings of up to 2,000 people for special events, but also designed to be a pleasant passive experience for the day-to-day visitor.

Funds of $6,083,085 have been budgeted for this project. Preliminary construction estimates indicated a potential construction cost of $5.93 million depending on the features included and the materials used. This figure did not include design, construction support or contingency. The available funds were not sufficient to pay for the originally proposed project. Staff received direction from Council in May 2003 to proceed with a phased project that could be built within the available funding. The phased project will start construction in August 2003 and be complete by August 2004. The elements of the project that are not being constructed at this time can be added in the future, as funding becomes available.

ANIMAL FIELD AND SHELTER SERVICES

On July 20, 2000, Sunnyvale entered into a 7-City Joint Powers Agreement, the Silicon Valley Animal Control Authority (SVACA), to ensure the continued provision of State-mandated animal shelter services. Funds in the amount of $2,380,060 were included in the capital budget in FY 2000/2001 for Sunnyvale's contribution to construct a new animal shelter facility to be operated by SVACA.

Due to cost considerations, the City Council made the decision in March 2003 to withdraw from SVACA and enter into a long-term contract with the City of Palo Alto for animal shelter services. Sunnyvale will continue to receive animal sheltering from the Humane Society of Silicon Valley on a short-term basis for three years while the Palo Alto Animal Shelter has been enlarged to accommodate our animals.

The recommended FY 2003/2004 Budget includes $1.1 million for the City's capital contribution to Palo Alto's shelter expansion project. This allows $1,101,319 to be returned as project savings to the General Fund. Additionally, the reduced annual operating costs resulting from the new arrangement will be approximately $200,000 per year. These substantial savings have been reflected in the General Fund Long-Term Financial Plan.

DETAILED FUND REVIEWS

So far, this Transmittal Letter has focused on those factors affecting the overall budget of the City. As noted earlier, however, City finances are actually composed of a number of diverse businesses. As a result, the following review will provide strategic long-term, as well as important short-term, financial highlights for each individual fund.

GENERAL FUNDS

The General Fund is used by the City to account for all financial resources except those required by law or practice to be accounted for in another fund. Due to the fact that operation of the Gas Tax Fund is inextricably intertwined with the General Fund, it is included in the General Fund discussion.

General Fund

The General Fund supports many of the most visible and essential City services, such as police, fire, road maintenance, libraries, and parks and open space maintenance. General government support functions are also included in this fund, and their costs are apportioned through the use of in-lieu fees to other City funds. Because the General Fund receives the preponderance of its revenue from taxes, it has been the most affected by voter-approved initiatives and State legislative actions. As a result of such action over the past decade, revenues to the General Fund are significantly less than they would have otherwise been. Additionally, the state of the regional economy has a direct effect on the General Fund, as we can see from our current budget crisis.

The General Fund has a very close relationship with several other funds. Those funds are the Community Recreation Fund, the Youth and Neighborhood Services Fund, the Gas Tax Fund, the Internal Service Funds, the Capital Projects Fund, the Infrastructure Renovation and Replacement Fund, and the Redevelopment Agency Fund. In each case, the condition of these funds has a direct bearing on the General Fund due either to contractual relationships or because the General Fund is a primary or significant source of financial support. The relationship between these various funds, where appropriate, will be discussed as a part of the General Fund, as well as in the review of each of these individual funds.

General Fund Revenues

<u>Revenue Estimation Methodology</u>

All revenue assumptions and projections are reviewed and revised each fiscal year. Further, considerable analysis is undertaken to identify the key elements that impact our major revenue sources so that the projection methodology is reliable over the long-term. Historical data underscores the fact that a significant swing in revenues can occur due to economic cycles. From a low in 1990 to the high in 2000, the economy has produced very different revenue yields to the City in a number of major categories. Projecting revenues based on the high point of the economic cycle could overstate the City's financial position significantly for future years and could result in spending patterns that cannot be sustained. Conversely, projecting revenues from the lowest point of the economic cycle could understate the long-term financial position of the City and cause unnecessary service reductions.

Each revenue source has its unique characteristics that have been used to make projections. In general, estimates of actual expected revenue for each major source are used to calculate FY 2003/2004 figures and one or two years beyond. For the balance of the financial plan, however, projections are based on average historic yields over a defined economic cycle modified for present circumstances. Recognizing that Silicon Valley is likely to go through several economic cycles during the 20-year projection time frame, staff believes that this methodology is more accurate over the long-term because it projects revenues from the "trend line" rather than from any given high or low point. This approach has served the City very well and prevented us from adding or reducing services based upon a one-year revenue condition. However, because it is based on historic averages, it should be expected that revenues would actually perform considerably better than projected in some years and considerably worse in others.

The on-going national recession has resulted in steep declines in City revenues. Although staff programmed these declines into the City's long-term financial plan, the reduced revenues from many of the City's most important revenue sources "thinned out" our ability to absorb future revenue losses or increased costs. Key revenues have continued to decline this fiscal year instead of stabilizing.

Six key sources generate nearly 90% of the City's General Fund revenues. They are: Sales Tax, Property Tax, Transient Occupancy Tax, Motor Vehicle License Fees, Utility Users Tax/Franchise Fees, and construction-related taxes and fees. The current budget projected that revenues from many of these sources would stop falling this year. Revenues were projected to stabilize this fiscal year, and slowly increase to actual revenue base levels by FY 2007/2008.

Now, even this revenue picture appears too optimistic. Specifically, the city is facing marked decreases in the amount of Sales Taxes, Transient Occupancy Taxes, and construction related revenue collected in FY 2002/2003.

Table II, below, reflects projected major sources of General Fund revenues for FY 2003/2004 and compares those sources with the FY 2002/2003 revised projections. FY 2001/2002 actuals are also included.

Table II Recommended Revenues – General Fund

Revenue Character	2001/2002 Actual	2002/2003 Revised Projection	2003/2004 Recommended Projection	% Growth 2003/2004 over 2002/2003
Sales Tax	27,269,784	24,200,000	24,239,000	0.16%
Property Tax	22,817,384	23,255,628	23,379,998	0.53%
Transient Occupancy Tax	6,320,197	5,300,000	5,300,000	0.00%
State Shared	8,318,078	7,966,891	7,921,780	-0.57%
Interest	5,051,366	4,165,392	3,461,987	-16.89%
Franchises	5,494,040	5,343,736	5,421,740	1.46%
Utility Users Tax	5,687,657	5,848,219	6,006,721	2.71%
Permits and Licenses	4,391,446	2,978,967	2,483,576	-16.63%
Inter-Fund Revenues	3,647,528	1,744,796	1,706,199	-2.21%
Other Taxes	2,005,611	1,767,070	1,797,520	1.72%
Service Fees	1,448,338	1,216,683	1,242,057	2.09%
Service Fee Adjustments to Full Cost	0	0	150,000	N/A
Rents and Concessions	1,224,326	1,197,069	1,198,814	0.15%
Fines and Forfeitures	809,963	624,719	654,776	4.81%
Miscellaneous	595,826	563,862	556,598	-1.29%
Federal Government	14,064	11,431	0	N/A
TOTAL	**95,095,610**	**86,184,463**	**85,520,766**	**-0.77%**

In the following section, detailed discussions of the City's six major revenue sources will include explanations of the revenue forecasts for FY 2003/2004 and beyond. However, for several other revenue sources the comparison between revised projections for FY 2002/2003 and recommended projections for FY 2003/2004 shown on Table II needs some explanation.

The decrease shown in anticipated interest earned is the result of reserve balances being drawn down to balance the recommended FY 2003/2004 Budget. This situation will be discussed in detail in the section below on *General Fund Reserves*.

As will be discussed below, the estimates for construction-related revenues for FY 2003/2004 have been reduced to reflect the current economic slowdown. This has resulted in declines in two categories represented in Table II. The drop in anticipated construction-related revenue largely accounts for the FY 2003/2004 decline in anticipated revenue from Permits and Licenses. The decline in anticipated Construction Tax is the reason behind the fact that revenues associated with Other Taxes is relatively flat.

Miscellaneous Revenues are made up primarily of contributions from developers and others and income generated from miscellaneous leases. Because this category is one-time and varied in nature, we have used an historical average to project future receipts.

As part of the City Manager's strategic 6-Point Action Plan to address the budget crisis, staff reviewed city services for potential cost recovery. As a result of this review, staff has adjusted service fees to recover full costs as necessary. Further, new fees for services that were previously not recovered and therefore subsidized by the City have been proposed. A number of these new fees have been projected to contribute considerable levels of new revenue.

Additionally, four major new fees have been proposed and included in the Fee Schedule. These fees, and their anticipated levels of annual revenue, are shown in the chart below.

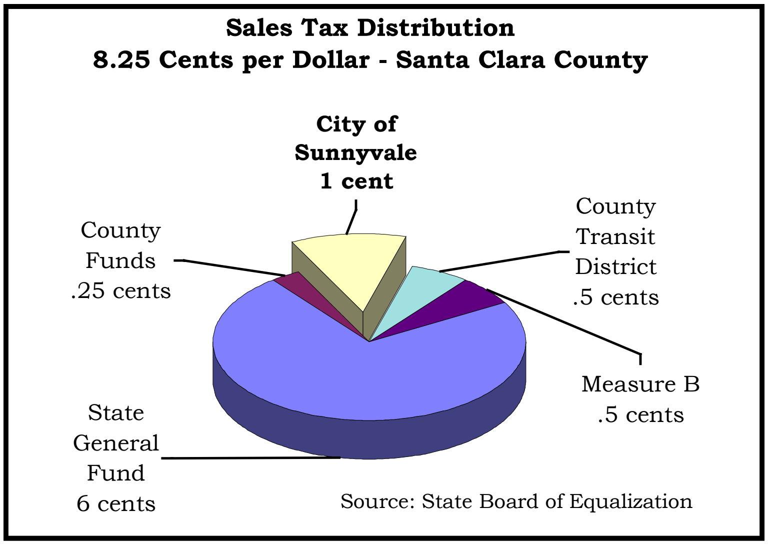
Major New Fees and Charges		
Department	**Proposed Fee**	**Estimated Annual Revenue**
Community Development	General Plan Maintenance Fee	$75,000
Finance	Business License Processing Fee	$157,690
Department of Libraries	DVD/Video Rental Fee	$300,000
Department of Public Safety	False Fire Alarm Fee	$100,000

All of these fees except for the DVD/Video Rental Fee will take effect in FY 2003/2004 and their revenues have been incorporated into the recommended FY 2003/2004 Budget. The DVD Fee will be in place for FY 2004/2005.

Following are detailed discussions of six of the General Fund's major revenue sources: Sales and Use Tax, Property Tax, Utility Users Tax/Franchise Fees, Transient Occupancy Tax, construction-related revenues, and State-shared revenues.

Sales and Use Tax

Sales and Use Tax represents the largest source of revenue to the General Fund (28.08% in FY 2002/2003). In FY 2000/2001 Sales Tax represented the largest revenue source and constituted 34.6% of total revenue. Since FY 2000/2001 Sales Tax revenue has fallen at a dramatic rate of 35.7% or roughly $13.4 million. The graph below shows how Sales Tax dollars are distributed within Santa Clara County. The State receives the largest share of the eight and one quarter cents per dollar of sales, while cities receive only one cent of the rate.



Sales and Use Tax is composed of two parts - general retail sales and business-to-business sales. In Sunnyvale, as well as some other Silicon Valley cities, an unusually high proportion of overall Sales Tax has traditionally been business-to-business in nature. During FY 2001/2002, our ratio was 48% retail to 52% business-to-business. It is telling to note that our ratio for the most recent quarter is now 62% retail to 38% business-to-business. When compared to the State of California ratio of 82% retail to 18% business-to-business, it is clear how dependent our Sales Tax revenue is on commercial spending.

Our revised Sales Tax estimate for FY 2002/2003, down more than 11% or $3.1 million compared to our actual receipts for FY 2000/2001, reflects the "bursting" of the economic bubble. This estimate is based on actual receipts to date, and has been confirmed by our Sales Tax consultant, Hinderliter, deLlamas & Associates (HdL).

In forecasting our Sales Tax revenues for the next two years and the balance of the financial plan, three fundamental questions were addressed. First, what is our actual underlying Sales Tax base? Second, when will we return to the actual base level? And, finally, what will be the rate of recovery?

Information discussed above, and also in the section of this Transmittal Letter on *Current Economic Conditions and Outlook*, indicates that the Sales Tax revenues enjoyed by the City in FY 1999/2000 and FY 2000/2001 were a "bubble" that does not reflect the sustainable level of our Sales Tax base. This has led us to the conclusion that FY 1998/1999 is a better reflection of the underlying level of Sales Tax that we can expect when the recovery occurs. Consequently, our projections are based on returning to that level when the economy has fully rebounded.

The questions as to when the recovery will occur and what will be the rate of recovery are a bit more problematic. It is clear that Silicon Valley will recover more slowly than the rest of the Bay Area and California because of our dependence on technology-related business. Further indications are that the recovery will not be sharp, but will be slow and measured. Our projections, as described below, reflect these assumptions. It should be noted, however, that the City's Sales Tax receipts can lag the marketplace by up to six months, and so our revenue projections will reflect this delay.

Projections for FY 2003/2004 are that the City's Sales Tax revenue will hold flat at $22,900,000. This projection is based upon the stagnant nature of the economy at this time. Our projection for FY 2004/2005 is based upon an 8-year historical average, adjusted for inflation, <u>excluding FY 1999/2000 and FY 2000/2001 as statistical anomalies.</u> We have estimated increases of 4% for the remainder of the financial plan as this is consistent with our historical pattern of growth.

In summary, Sales Tax revenues have experienced wild swings over the last several years. Sunnyvale experienced unprecedented growth of about 20% per year in Sales Tax receipts in FY 1999/2000 and FY 2000/2001 due to a "boom" in high technology business. Unfortunately, this level of revenue was not sustainable. The current economic recession was already impacting City revenues 2 years ago, as the stock market was undergoing dramatic declines and numerous companies across the nation were implementing cost saving measures that included reducing capital investment. We are now anticipating a mild recovery over the next several years to a more realistic on-going level.

Finally, two major factors that may have an impact on our Sales Tax revenues should be noted. First, we have not included any potential new revenue to be generated from our economic development efforts in the Downtown area. When the Town Center Mall remodel project has been completed, the City will be in a better position to identify realistic revenue and expenditure effects. Second, we have not included any recognition of the positive effect of Internet commerce legislation that is currently being considered at the State level.

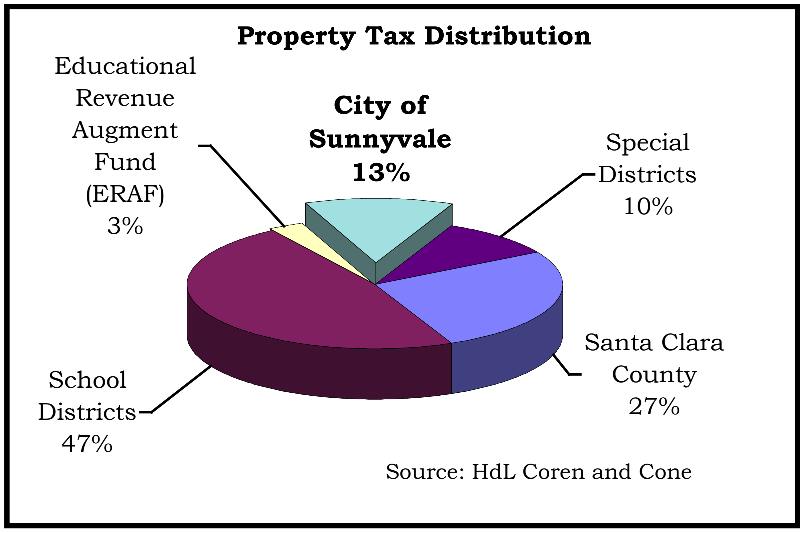
<u>***Property Tax***</u>

The Property Tax represents the second largest source of General Fund revenue (26.98% in FY 2002/2003). Property Tax is up considerably as a percent of General Fund revenues compared to the prior year as a result of sharply declining receipts from Sales Tax.

The following graph shows how Property Tax dollars are distributed in Santa Clara County. Sunnyvale receives 13% of every Property Tax dollar paid by property owners in the City.

Property Tax has also been the revenue most affected by voter initiatives and legislative actions. With approval of Proposition 13 more than 20 years ago, Property Tax revenues were reduced by two-thirds and thereafter limited to 2% annual increases or the CPI, whichever is less. In the early 1990s, the State legislature shifted a larger portion of the Property Tax to schools. This shift was made to the State's Educational Revenue Augmentation Fund ("ERAF") to backfill a portion of the State's obligation for school funding. As shown in the graph above, this "ERAF shift" is now 3% of the Property Tax dollar, representing an annual loss to the City of Sunnyvale currently amounting to approximately $6.3 million.

Even with the recent declines in the commercial real estate market, our Property Tax revenues have grown. This is due to the fact that the Property Tax typically lags economic conditions by a year or more because of the assessment schedule and the time it takes to get a property transactions onto the rolls. Previous increases in real estate values and an increase in new construction over the last several years are now being reflected on the assessment rolls. We expect a 2% increase in Property Tax revenue in FY 2002/2003 compared to the amount received in FY 2001/2002.



Revenue from secured Property Tax, which represents about 80% of total Property Tax revenues, is projected to remain flat next year. While the residential market appears to be holding its own, there are significant declines in the value of commercial property due to the area's high vacancy rates. However, the Santa Clara County Assessor has proactively reduced assessed valuations Countywide for both residential and commercial parcels. As reported by the *San Jose Mercury News* on March 21, 2003, the Assessor reduced the assessed valuation of 29,014 parcels by $4.45 billion. This was the largest one-year reduction in County history. More than half of the reductions affected homes, but an unprecedented $2 billion came from reassessments of commercial/industrial properties. The County Assessor took this unusual step of proactively reassessing commercial properties because of the economic downturn and its effect on businesses. Therefore, we expect the effect of assessment appeals to be minimal because of the Assessor's actions.

In the following year, FY 2004/2005, we expect real growth of 1% over the statutory allowed inflation, followed by 1.5% real growth for the remainder of the financial plan. For the remaining Property Tax categories, we have based the FY 2003/2004 estimates on the average actual receipts for the most recent five years through FY 2000/2001.

Utility Users Tax and Franchise Fees

Utility Users Tax (UUT) and Franchise Fees combined represent the third largest source of General Fund revenue (13% in FY 2002/2003). Historically, these two revenue categories have been combined because one of the primary sources of revenue for both is sale of electricity and gas.

As indicated in Table II, receipts from UUT are expected to increase by nearly 3% in FY 2002/2003 compared to last year's receipts. This growth is primarily driven by an increase in receipts from natural gas suppliers and phone services. We anticipate that gas prices will moderate somewhat in FY 2003/2004 and thus project a decline in revenues from gas receipts. All other revenues are projected to increase by 3% from FY 2004/2005 through FY 2012/2013.

As was mentioned in last year's Transmittal Letter, the California Department of Water Resources (CDWR) was disputing the right of municipalities to collect Franchise Fees on CDWR power sales. On February 13, 2003, the California Public Utilities Commission (CPUC) issued a decision on this dispute. In the decision, CPUC decided that CDWR sales are not subject to franchise fees but are subject to franchise fee surcharges under the Municipal Public Lands Use Surcharge Act. The CPUC ordered the Energy Division of PG&E to convene a series of workshops to develop the data and methodology to compute the surcharge. At this time the fiscal impact to the City of Sunnyvale is unknown. Staff will continue to monitor this situation to protect this important source of revenue.

Projections of Franchise Fee revenues for FY 2002/2003 reflect a decline of about 2.75%, due to lower than projected Franchise Fees from AT&T Cable (Comcast) and Solid Waste Franchises.

We have included estimated Franchise Fee revenue increases of 3% per year for most of the remainder of the financial plan, beginning in FY 2003/2004.

State-Shared Revenue

State-shared revenues represent about 9.24% of General Fund revenues in the current year and are the fourth largest revenue source. Vehicle License Fees (VLF) make up over 94% of State-Shared Revenues. VLF is an annual fee on the ownership of a registered vehicle in California, levied in place of a property tax on vehicles. These fees are collected by the State and distributed to local jurisdictions on a per-capita basis. Total revenues are allocated 61% to the State, 27% to counties, and 12% to cities. The local portion of the VLF is constitutionally protected as to allocation formula.

The revised FY 2002/2003 estimate for VLF based on the state's projection is $7.5 million, up by 2% over the FY 2001/2002 receipts.

Growth in this revenue in prior years had been driven by extremely strong auto sales resulting from the robust economy. Estimates for FY 2002/2003 assumed that auto sales would drop about 5% as the economy softened. However, even as the economy faltered, statewide vehicle sales remained surprisingly strong, in part due to unusually generous financing offers. Even so, we do not anticipate growth in this revenue in the near future and have held our estimates flat through FY 2003/2004. Then, we expect modest growth of 4% through the end of the financial plan.

It should be noted that this projection does not take into account the fact that approximately two thirds of these receipts are potentially subject to reduction by the State. As part of the State's 1998 budget, the VLF was cut by 25%. In subsequent years, additional cuts were made, and currently the reductions equal 67.5% of the total fee. To date, the State has been backfilling the local portion of the revenue by giving an equivalent amount to cities and counties from its general fund.

Unfortunately, this revenue is particularly vulnerable to State takeaways, since the backfill is not constitutionally guaranteed.

Currently, it appears as though the State will pull the "trigger" and raise the VLF back to its pre-1998 levels. For more information on the status of the Vehicle License Fee situation, please refer back to the *Future Fiscal Issues* section of this Transmittal Letter.

Transient Occupancy Tax

Transient Occupancy Tax (TOT) represents 6.15% of General Fund revenues in the current year and is the fifth largest revenue source. In prior years, TOT has been the third largest source and constituted about 10% of the total.

The year 2000 was a banner year in the hotel industry, and especially so for Silicon Valley hotels. During the boom of FY 1999/2000 and FY 2000/2001, the City's TOT revenue enjoyed significant growth. Beginning in approximately 1995, improved economic conditions led to higher occupancy rates and room charges, as well as the addition of several new hotel and motel properties. Our TOT rate was also increased from 8% to 8.5% in 1995. However, this revenue is particularly susceptible to economic cycles because both occupancy rates and room rates are closely linked to economic conditions. The bulk of our TOT revenue stems from weekday business travel.

Over the past two years, Sunnyvale hotels have seen significant reductions in both average occupancy rate and average room rate. These decreases are directly related to the drastic downturn in the local economy, the Severe Acute Respiratory Syndrome (SARS) epidemic, and the current state of uncertainty surrounding the global economy.

As a result of these economic factors, we have seen a dramatic drop in our TOT revenues this year, which we forecast will be approximately 16% lower than last year's receipts. Compared to FY 2000/2001, this translates to a reduction of more than 51% or $5.4 million.

As the controlling economic factors affecting TOT receipts are not anticipated to significantly improve, we are holding the estimate for FY 2003/2004 at the same level as FY 2002/2003. We estimate growth in TOT receipts of 6% in FY 2004/2005 and throughout the rest of the financial plan. This growth estimate represents a return to the historical average rate of annual increase.

Construction-Related Revenue

Construction-related revenues represent about 5% of General Fund revenues in the current year. This category includes Construction Tax as well as receipts from the issuance of building, electrical and other permits. Plan Check Fees are also reflected here. Due to a number of large projects, as well as general increases in construction, these revenues showed extraordinarily large gains in FY 1999/2000 and FY 2000/2001. The City's Chief Building Official has been monitoring construction trends and has revised the current year's original projection downward by 20% to reflect actual levels of activity. We have held this projection flat for FY 2003/2004 with an increase only for inflation. The following years are based on an eight-year average adjusted for inflation.

General Fund Expenditures

Table III outlines the recommended expenditures for the General Fund and Gas Tax Fund combined. Although these are separate funds, they are added together in Table III to better represent the proposed changes from one year to the next. It is in the interest of the City to expend Gas Tax Funds for eligible projects and operating activities before utilizing General Fund money. This results in increases and decreases from year to year regarding the amount of road maintenance operations that are funded by the Gas Tax Fund and General Fund respectively. By combining the two funds, a clearer picture results as to the year-to-year changes.

As Table III below indicates, the overall combined recommended expenditures of the General Fund and Gas Tax Fund for FY 2003/2004 are 5.05% below the Revised FY 2002/2003 Budget. However, because certain aspects of the budget can change dramatically from year to year, notably capital, infrastructure and special projects, a more precise understanding of the comparative budget is in the operating area. The operating portion of the recommended FY 2003/2004 Budget is virtually the same (.04% above) as the Revised FY 2002/2003 Budget.

Table III Recommended Expenditures – General Fund and Gas Tax Fund Combined

Expenditure Character	2001/2002 Actual	2002/2003 Revised Budget	2003/2004 Recommended Budget	% Growth 2003/2004 over 2002/2003
Operating	83,603,690	92,129,121	101,099,086	
Recommended Operating Reductions	0	0	(7,774,948)	
Recommended Rental Rate Reductions	0	0	(1,161,964)	
Operating Sub-Total	83,603,690	92,129,121	92,162,174	0.04%
Projects	4,472,684	9,218,172	2,855,534*	
Recommended Project Reductions	0	(1,482,754)	0	
Projects Sub-Total	4,472,684	7,735,418	2,855,534	-63.08%
Debt	414,617	415,648	416,568	0.22%
Lease Payments	1,218,753	1,215,678	1,216,678	0.08%
Equipment	282	300,000	0	-100.00%
TOTAL	**89,710,026**	**101,795,865**	**96,650,954**	**-5.05%**

* The FY 2003/2004 Projects Budget includes the Public Safety Expanded Recruitment project which was fully budgeted in FY 2002/2003, but anticipated to be spent over two years.

The operating total reflected in the above table includes approximately $7.8 million in departmental and $1.1 million in rental rate reductions. In normal times, the operating budget of the General Fund would have increased for next fiscal year by approximately $7 million, or 7.6% due to continuing increases in base wages and benefits for our employees. The operating reductions and decreases in rental rates essentially offset the projected increases in personnel costs.

The recommended FY 2003/2004 Budget is built on several key salary and benefit assumptions. First, salary increases have been projected based on preliminary survey information from the Human Resources Department. The chart below indicates assumptions for salary increases in the future:

Labor Unit	FY 2003/04	FY 2004/05	FY 2005/06 – FY 2012/13	FY 2013/14 – FY 2022/23
SEA/Confidential	6.56%	3.00%	3.00%	4.00%
PSOA – Officers	6.19%	5.00%	3.00%/4.00%	4.00%
PSOA – Lieutenants	5.94%	5.00%	3.00%/4.00%	4.00%
COA	6.25%	3.00%	3.00%	4.00%
SEIU	13.67%	12.00%	3.00%	4.00%
Management	3.00%	3.00%	3.00%	4.00%

In general, all employees saw significant salary increases as the result of our local labor market and the City's competitive compensation philosophy during the past several years. Our labor agreements for the four bargaining units are still in effect. As Council knows, these agreements contain formulas that determine what salary increases will be in the future. These formulas are based on market comparisons with predetermined comparable cities within our labor market. We are not aware that a significant number of our comparator cities have asked for or received wage concessions from their employees this year. However, as shown in the above table, we are assuming that economic conditions will moderate future salary increases in our comparator cities.

An equally disturbing trend, with significant fiscal implications for the future, is the rapid escalation being experienced in the cost of personnel benefits. The recommended FY 2003/2004 Budget contains an increase of 16% in expenditures for the Employee Benefits Fund over this current year, and 21.9% for FY 2004/2005. The largest component of these increases by far is the cost of retirement contributions, which are rising 42% for FY 2003/2004 and 62% for FY 2004/2005. The rate of escalation of these benefits, if left unchecked, is unsustainable in the longer term and will ultimately have severe effects on our ability to provide services to our citizens. Detailed discussions of each of these costs are included in the *Detailed Fund Reviews* section of this Transmittal Letter under *Employee Benefits and Insurance Fund.*

It should also be noted that the recommended FY 2003/2004 Budget includes an additional $200,000 in FY 2003/2004 and FY 2005/2006 for election cost increases from the County of Santa Clara. Section 1400 of the Sunnyvale City Charter requires that the General Municipal Election to fill City elective offices be held in odd-numbered years on the date established for election of elementary school district board members. The estimated cost of conducting the 2003 General Municipal Election through the County of Santa Clara is approximately $360,910 or $6.56 per voter. The number of ballot types increased significantly due to redistricting after the 2000 Census. This drove the printing cost significantly higher than recent elections. The estimate is based on shared costs with other jurisdictions. $165,782 for conducting the 2003 General Municipal Election was budgeted in the FY 2003/2004 budget.

Staff is proposing that Council consider a Study Issue to explore the feasibility of consolidating municipal elections with State and Federal elections in even-number years. If Council supports this change, it would require that a Charter Amendment measure be put before the voters on the November 2005 ballot. If the measure is passed by the voters, in accordance with the change of the election date, the terms of office of the members of the City Council who are presently serving with a term expiring in November 2007 would be extended to November 2008.

Based on estimates received from the Santa Clara Registrar of Voters an estimated $181,000 would be saved by consolidating the election during even-number years. An added benefit is that voter turnout tends to be higher in even-number years, when state and federal offices are being contested.

Table IV, below, outlines the recommended expenditures for the General Fund only. Looking at just the General Fund, the proposed operating expenditures for FY 2003/2004 are 1.17% below the Revised FY 2002/2003 Budget. Total General Fund recommended expenditures, including projects, debt, and equipment, are 4.56% below the Revised FY 2002/2003 Budget.

Table IV Recommended Expenditures – General Fund

Expenditure Character	2001/2002 Actual	2002/2003 Revised Budget	2003/2004 Recommended Budget	% Growth 2003/2004 over 2002/2003
Operating	81,944,713	91,229,121	99,099,086	
Recommended Operating Reductions	0	0	(7,774,948)	
Recommended Rental Rate Reductions	0	0	(1,161,964)	
Operating Sub-Total	81,944,713	91,229,121	90,162,174	-1.17%
Projects	2,980,420	7,011,088	2,806,026*	
Recommended Project Reductions	0	(1,047,422)	0	
Projects Sub-Total	2,980,420	5,963,666	2,806,026	-52.95%
Debt	414,617	415,648	416,568	0.22%
Lease Payments	1,218,753	1,215,678	1,216,678	0.08%
Equipment	282	300,000	0	-100.00%
TOTAL	**86,558,785**	**99,124,113**	**94,601,446**	**-4.56%**

* The FY 2003/2004 Projects Budget includes the Public Safety Expanded Recruitment project which was fully budgeted in FY 2002/2003, but anticipated to be spent over two years.

The contributing factors previously mentioned in the General/Gas Tax Fund discussion are applicable here as well.

General Fund Projects

This is the first year of the two-year budgeting cycle for projects. As such, staff efforts were directed towards the review of both currently existing projects and newly proposed projects. This Transmittal Letter focuses on newly developed or significantly revised projects. Descriptions and detailed financial information on all projects can be found in the budget document, *Volume II Projects Budget*. There are two helpful indexes of all the City's projects, one alphabetically oriented (by project name) and the other numerically oriented (by project number).

As mentioned earlier in this Transmittal Letter under *Major Project Efforts*, General Fund-related projects are found in several places in the budget. They are in the General Fund, the Gas Tax Fund, the Capital Projects Fund, and the Infrastructure Renovation and Replacement Fund. In general, these categories are considered to be related to the General Fund because it is the ultimate source of financial support through contributions or transfers. For example, the General Fund is scheduled to make annual contributions to fund its infrastructure projects in the Infrastructure Renovation and Replacement Fund and to fund its capital projects in the Capital Projects Fund.

Several major capital or special projects have been discussed earlier in this Transmittal Letter in the *Major Project Efforts* section. The following are new projects affecting the General Fund included in the recommended FY 2003/2004 Budget:

- **Neighborhood Preservation Abatement Efforts:** This project provides for expanded neighborhood preservation by finding and resolving nuisance, health and safety related cases within the City. It is scheduled for FY 2003/2004 and FY 2004/2005, and it is funded by abatement cost recovery from the property owner.

- **Recreation and Open Space Sub-Elements:** This project provides funding for updating the Recreation and the Open Space Sub-Elements, which were last updated in 1993 and 1992 respectively. It is scheduled for FY 2005/2006 and is funded from General Funds.

- **Sidewalk, Curb, and Gutter from Mathilda Avenue to the Tennis Center:** The purpose of the project is to extend an existing sidewalk that borders the South side of the Tennis Center parking lot to the Mathilda Ave. entrance. Approximately 250 linear feet of standard city sidewalk, curb and gutter will be constructed. $25,000 is programmed in FY 2003/2004 from Gas Tax funds.

- **Sunnyvale Historical Museum:** This project is the City's contribution of $500,000 in FY 2003/2004 to support the development of an Historical Museum at Orchard Heritage Park. The Sunnyvale Historical Society and Museum Association (SHSMA) has pledged to raise the remainder of funds for the project and the City has begun the process of entering into an agreement with SHSMA. This project covers the

City's share of funds committed to SHSMA. Once constructed, the museum will be operated by the SHSMA. As discussed earlier, staff is proposing the use of Proposition 40 funds for this project. If these funds are not available, it is recommended that the remaining Park Dedication Fund reserves be used along with the *Non-Recurring Events Reserve* in the General Fund for the project.

- **Gas Line Replacement at the Community Center:** This project provides for the replacement of nearly 2,000 feet of gas line at the Community Center. The replacement is necessary for building safety reasons and will bring the gas line at the Center up to current code. The gas line at the Center was originally installed in the late 1970's and is now in need of replacement. The project has been programmed in the Infrastructure Fund in the amount of $132,495 for FY 2003/2004.

- **Sport Center Gym Lighting Replacement:** This project provides for replacement of old lighting fixtures with newer systems that ensure safety, offer improved quality with uniform light distribution at the floor level and reduce energy use. $37,706 has been programmed in FY 2003/2004 in the Infrastructure Fund for this purpose.

- **Theater Rigging Replacement:** This project would fund the repair or replacement of the stage rigging system at the Sunnyvale Community Center Theatre. The repairs are necessary to provide a safe environment for the Community Theatre users, ensure compliance with CAL-OSHA standards, and lessen the opportunities for failures of rigging equipment. $31,031 has been programmed in the Infrastructure Fund in FY 2003/2004 for this project.

- **Raynor Activity Center Site Improvements:** This project provides $188,354 in the Infrastructure Fund over a five-year period to fund on-going infrastructure maintenance needs at the Raynor Activity Center site. This project would service and/or replace items such as hardscape, windows, plumbing, electrical and other facility infrastructure maintenance to ensure the safety of the complex.

- **Murphy Avenue Decorative Street Lighting Replacement:** This project provides $15,762 in the Infrastructure Fund in FY 2003/2004 to maintain the decorative tree lights and prune the trees on Murphy St. This project is recommended for funding in FY 2003/04. Staff recommends that future replacement beyond this time be funded by the businesses in the Downtown area through a Business Improvement District.

General Fund Reserves and Set-Asides

One of the most powerful aspects of multi-year financial planning is its capability to recognize trends over time and begin at an early point to consider the necessary steps to alter the long-term forecasted position of a particular fund should that appear necessary. The reserves and set-asides contained in the General Fund's Long-Term Financial Plan play a pivotal role in the City's multi-year planning strategy.

The City has established five reserves in the General Fund that are restricted by prior policy or legal requirements to specific uses. Most of the City's reserves are established in accordance with policy adopted in the Fiscal Sub-Element of the General Plan. Policy 7.1B.8: states:

> "Reserves: Provide a prudent level of reserves for future unexpected expenses and revenue declines; to accumulate funds to support future planned capital improvements, and to level high and low expenditure years in the Ten-Year Resource Allocation Plan."

The General Fund currently has four reserves that are designed to be used according to the policy above. These reserves are contained in the General Fund's financial plan under the sub-heading, *Designated Reserves.*

The first is the *Contingencies Reserve* equal to 20% of the operating budget each year. This reserve is to be used only in case of emergency or disaster, and is not intended for normal unanticipated expenditures. In the Fiscal Sub-Element, the policy calls for this reserve to be 10% of operations, but Council policy in FY 1992/1993 changed it to 20% of operations. This reserve changes each year as operations of the General Fund either increase or decrease.

The General Fund also has an additional 5% of operating costs in the *Service Level Contingency Reserve.* This reserve was established in FY 1993/1994 to provide funds for increased service levels or costs in excess of inflation. In earlier years, the Resource Allocation Plan contained an on-going set-aside called the "One Percent of Operations Set-aside" that provided the ability to handle revenues that did not perform as well as projected and expenditures that increased more than inflation. This set-aside was replaced by the *Service Level Contingency Reserve*. It is important to note that the reserve is one-time, and once drawn down it is gone. The set-aside, on the other hand, was available each year and accumulated if not used.

A third reserve in the General Fund is the *Non-Recurring Events Reserve.* This reserve contains funds from FY 1997/1998 and FY 1998/1999 that resulted from greater than anticipated revenues and lesser than anticipated expenditures as this extraordinary economic cycle saw continued growth. By Council action, these types of one-time funds resulting from the peak of the economic cycle were set aside for significant high-priority capital and special projects and not used to add recurring services. In prior years, these funds were programmed over a several year period for the following major projects:

- Senior Center Construction,
- Animal Field and Shelter Facility Construction, and
- Fremont Pool Construction.

An additional $1.5 million was added to the *Non-Recurring Events Reserve* in the adopted FY 2001/2002 Budget to be spent as necessary on important one-time projects. The Adopted FY 2002/2003 Budget shows this reserve being reduced from $8,985,864 to $1,358,892, largely to pay for the Senior Center Construction project. During FY 2002/2003, $210,000 was also used for further costs associated with the Fremont Pool Construction.

A fourth reserve in the General Fund is entitled the *20 Year RAP Reserve.* This reserve functions to levelize economic cycles from year to year. By letting this reserve vary each year, the fund can absorb the cyclical effects of the economy and specifically plan for project-related expenditures. In essence, this reserve grows during periods of economic growth and is drawn down during the low points of economic cycles to maintain stable service levels.

The function of the *20 Year RAP Reserve* and its strength is particularly apparent in the recommended FY 2003/2004 Budget and Long-Term Financial Plan. In prior years when the City was experiencing strong economic growth, the reserve was building up over time to the $61 million level reached last year. Now, as the effects of the economic downturn are being fully felt, the reserve is available to provide a "cushion" to maintain City services at desired levels. Council will note that under current economic forecasts, the Long-Term Financial Plan shows the *20 Year RAP Reserve* being drawn down until FY 2013/2014, even with the proposed budget reductions. In FY 2014/2015 the *20 Year RAP Reserve* stabilizes and begins to grow again. Since the City policy is to fix the reserve at zero in the twentieth year, it is drawn down again over the final three years of the financial plan.

The *20 Year RAP Reserve* functions very effectively as the City positions itself to "live at the trend line." It prevents us from adding services at the top of the economic cycle that cannot be sustained, and it allows us to maintain the Council-approved services levels during economic downturns. This is in sharp contrast to jurisdictions like the State of California, which greatly increased spending during the boom and is now faced with making draconian expenditure reductions in the face of revenue shortfalls. Our citizens are well served by our longer term approach.

Finally, the City has one restricted reserve, the *Land Acquisition Reserve,* which has a balance of $3 million. This reserve was established in FY 1994/1995 for the purpose of purchasing land or property in the downtown area with an emphasis on future income generation through economic development. It has been used to purchase key parcels in the downtown area, and as the land is sold to the private sector, the reserve is replenished.

While not a reserve, another important element of the financial plan is the planned expenditure called *Fiscal Uncertainties.* The *Fiscal Uncertainties* line item is contained within the *Expenditures* section of the financial plan, and it represents the on-going latitude that is available to increase service levels, add new annual programs, or address unexpected fiscal pressures. This number is normally derived from the last year of the 20-year plan. It is essentially determined by setting the *20 Year RAP Reserve* at zero for the 20th year but maintaining the required contingency reserve. If a positive number appears in the *Fiscal Uncertainties* line in year one, this reflects the remaining latitude the City has to deal with any issues or assumptions not included in this recommended financial plan. If this number turns negative, then it reflects the amount of budget reduction and/or revenue increase that is needed at the beginning of the planning period in order to avoid the long-term plan effectively going into true deficit.

Staff used this methodology as we started the budget reduction process to determine the amount of the on-going structural deficit in the General Fund. This deficit, which was approximately $14-15 million, was eliminated by the expenditure reductions and revenue enhancement proposed in the 6-Point Action Plan discussed previously. During this calculation, the *Fiscal Uncertainties* line item was held at the level contained in last year's Long-Term Financial Plan. For the recommended FY 2003/2004 Budget, the *Fiscal Uncertainties* line item was then reduced by $500,000 as part of the budget reduction process. For FY 2003/2004 and FY 2005/2006 it was reduced further to accommodate the increases in election costs received from the County of Santa Clara. By FY 2006/2007 the *Fiscal Uncertainties* line item stabilizes at about $300,000 and increases with inflation throughout the rest of the planning period. While small, this line item does provide the City with some latitude to deal with any additional fiscal pressures that may occur or any unexpected requirements for ongoing service level increases.

Also included in the General Fund financial plan is a set-aside entitled *Paramedic Services Set-Aside*. This planned expenditure was established to provide on-going enhancements to our emergency medical services. As part of the budget process for FY 2003/2004, we are recommending that $385,512 be appropriated to the Public Safety Department to bring our emergency medical services up to County standards. The remainder of the set-aside, $155,938, has been returned to the General Fund as part of the budget reduction proposals.

Public Facilities (City) Space Issues is the final set-aside included in the General Fund financial plan. These funds had been identified to address the City's long-term space needs. Because of the budget crisis, any additions to the City's office facilities have been put on hold. Therefore, this set-aside has been reduced to $250,000 each year throughout the planning period.

General Fund Financial Position

As stated earlier, the City's long-term financial position is balanced over the 20-year planning period in spite of our worsened economic situation. The City's revenue position has weakened considerably due to the continued economic downturn in the region. Additionally, there are a number of pressures on the expenditure side that are growing significantly faster than inflation. Items in this category are primarily personnel costs and benefits. The General Fund budget has been balanced through a series of reductions and increases in fees and charges. However, the fiscal issues and challenges outlined earlier do not impact only the City of Sunnyvale, and our long-term approach to financial planning puts us in a far better position to address them.

Gas Tax Fund

The Gas Tax Fund is required by State law to account for gas taxes collected and allocated by the State. These taxes are levied on gasoline and other motor fuels in terms of cents per gallon, and these funds are then distributed to the State, cities and counties on a formula based on population. Revenue forecasts for this fund utilized year-to-date projected receipts increased by the Association of Bay Area Governments (ABAG) estimated population growth rate for Sunnyvale.

Beginning in FY 2001/2002 new state funding for streets and road systems (AB 2928 - State Traffic Congestion Relief Program) is held and accounted for in the Gas Tax Fund as required by state law. A complete discussion of this revenue source and the projects associated with it can be found in the *Major Project Efforts* section of this Transmittal Letter.

Gas Tax funds are spent on maintenance and capital related to public streets and highways. As noted in the previous discussion of the General Fund, the Gas Tax Fund works in tandem with the General Fund. Essentially, a level of Gas Tax funding for operations is established, with remaining funds used to cover Gas Tax-eligible capital projects.

Operating expenses programmed for street maintenance in this fund are $2 million for FY 2003/2004 and $1 million for FY 2004/2005. In future years, operating expenses vary from $2 million to $3 million each year.

The budget reduction process that the Council undertook during the last five months resulted in the defunding of $435,332 in capital projects that are contained directly in the Gas Tax Fund. An additional $1,960,703 in projects that are funded from Gas Tax transfers to the Capital Projects Fund was defunded. A more detailed description of this process is contained in the *Budget Reduction Process* and *Project Budgeting Process* sections found earlier in this Transmittal Letter.

One new project is funded with Gas Tax revenues in FY 2003/2004. This project is Sidewalk, Curb and Gutter from Mathilda Avenue to the Tennis Center ($25,000). A brief description of this project is included in the *General Fund Projects* section of this Transmittal Letter.

ENTERPRISE FUNDS

The Enterprise Funds of the City incorporate programs and activities that are either fully self-supporting by way of user charges and fees or partially self-supporting. Those that are partially self-supporting require some level of transfer from the City's General Fund.

The City has three utilities that are fully self-supporting, including the Water Supply and Distribution Fund, Solid Waste Management Fund, and Wastewater Management Fund. Additionally, the SMaRT Station® Fund has been established to account for operations at the Sunnyvale Materials Recovery and Transfer Station, which is a partnership among the three cities of Sunnyvale, Mountain View and Palo Alto. This fund consists of two sub-funds, one used to account for SMaRT Station operations and the other used to account for equipment replacement needs.

In April 2003 Council approved the following rate changes as recommended by staff:

Utility	Rate Change
Wastewater	7.0%
Water	10.0%
Solid Waste	4.0%

Each rate increase and the factors contributing to the need for such increases are discussed in detail below. As a result of these increases, monthly costs associated with solid waste, water, and wastewater services for an average residential customer will increase by 6.6% overall. It is important to note that even with the rate changes, Sunnyvale residents enjoy utility rates that are 28% lower than the average of surrounding communities. This amounts to annual savings of approximately $307 per household.

In prior years, the Patent Library Fund, which includes the Sunnyvale Center for Innovation, Invention, and Ideas (Sc[i]^3) program and reflects its services and revenues, was classified as an enterprise fund. This program required an annual General Fund subsidy for operations because fees did not cover the full cost of all activities. As discussed below, a study issue conducted in FY 2001/2002 concluded that the Patent Library program should be reduced and moved back into the Library facility. Financial changes associated with this recommendation include removing the enterprise fund designation, changing it to a special revenue fund, and eliminating the General Fund transfer. These recommendations were approved by the Council in mid FY 2001/2002. The Long-term Financial Plan for the Patent Library Fund is now discussed in the *Special Revenue Fund* section of this Transmittal Letter.

There is one enterprise fund that requires an annual transfer from the General Fund for operations because it is not fully sustaining. The Community Recreation Fund incorporates Leisure Services activities including golf, tennis, and recreation programs. The decision to utilize an enterprise fund approach for these programs was based on two factors. First is the existence of competition in the marketplace. Users of Leisure Services have a wide variety of other options to supply these services. Second is the desire that these programs be managed in an environment similar to the market. By this, we mean that issues of pricing, marketing and appropriate service niches are more applicable for these kinds of activities than for other City services.

Finally, the FY 1999/2000 Budget and Ten-Year Resource Allocation Plan created a new Information Technology Enterprise Fund to account for the City's efforts to market and sell the SunGIS computer system. For FY 2003/2004 this fund has been closed and its activities folded into the Technology Services Sub-fund of the General Services Fund.

Water Supply and Distribution Fund

The Water Supply and Distribution Fund accounts for all revenues and expenses related to the City-operated water utility. Expenses include costs for wholesale water, project-related costs, debt service, and other operating costs. Revenues consist of service fees for water and recycled water, water-related public works and construction fees, and interest income. Once expenditure levels are developed, then water rates must be set to maintain the fund in a sustainable financial position. The fact that Sunnyvale utilizes long-range financial planning and sets utility rates every year helps minimize wild rate swings.

A significant portion (66.5%) of the Water Fund's direct expenditure budget is the cost of purchased water, so each year staff reviews the costs of wholesale water and the quantities planned to be purchased. The City purchases water from two wholesalers: the San Francisco Public Utilities Commission (SFPUC) and the Santa Clara Valley Water District (SCVWD). Currently, we are paying $383 per acre-foot to SFPUC, and $420 per acre-foot to SCVWD.

In general, each of the City's suppliers provides price projections for a one to ten year period. Staff then takes these numbers, factors in all known price increases, and projects water usage over the long-term plan to optimize the use of the least expensive sources of water within the terms of the contracts. Of particular note this year are the substantial increases to the projected FY 2003/2004 water rates announced by SFPUC and SCVWD. The projected rate increases are 22.2% and 9.5% respectively.

The recommended FY 2003/2004 Budget assumes these substantial increases and projections provided by SFPUC for the next 10 years and by SCVWD for the next five years. This is significant because the SFPUC is projecting another substantial rate increase of 16% in FY 2004/2005 and further substantial rate increases in FY 2008/2009 and FY 2009/2010. The projections provided by each agency are as follows:

	SFPUC	SCVWD
FY 2003/2004	22.2%	9.5%
FY 2004/2005	16.0%	7.6%
FY 2005/2006	5.0%	8.1%
FY 2006/2007	1.9%	4.7%
FY 2007/2008	6.0%	6.3%
FY 2008/2009	25.0%	N/A
FY 2009/2010	17.9%	N/A
FY 2010/2011	11.0%	N/A
FY 2011/2012	10.0%	N/A
FY 2012/2013	6.0%	N/A

A major potential influence on water rates continues to be the need for significant improvement to the SFPUC's Hetch-Hetchy system infrastructure. As staff has mentioned for several years, SFPUC has identified a need for capital improvements to restore the reliability of the Hetch Hetchy system. The Hetch Hetchy system (the sixth largest in the nation) delivers an average of 206 million gallons of water per day to 2.4 million people in San Francisco, San Mateo, Santa Clara, and Alameda counties. Much of the system was built in the late 1800s and early 1900s and has reached or exceeded its life expectancy. The system crosses three major earthquake fault lines between San Francisco and its sources of water, 160 miles away in the Sierra Nevada mountain range. Seismic studies indicate that a major earthquake could cause system failure resulting in a loss of water for sixty days or more.

Sunnyvale is one of 29 jurisdictions outside of the City of San Francisco who make up approximately 70% of the system's customers (the "Suburban Users"). The SFPUC estimates that $2.9 billion of the needed capital improvements are directly related to the provision of water to communities outside of San Francisco. The SFPUC has identified the needed improvements and in May 2002 adopted a $3.6 billion Long Term Strategic Plan for Capital Improvements. In November 2002, the San Francisco voters approved a $1.6 billion bond measure, the largest ever approved in city history, to fund the San Francisco portion of the project. The remaining portion of the CIP is to be funded by the suburban users.

In order to address the infrastructure issues with the Hetch Hetchy system, and the SFPUC's lack of action with regards to the repair and maintenance of the system, the State Legislature, at the urging of the Suburban Users, passed three bills, all of which the Governor signed into law in 2002. The result of those bills was the creation of the San Francisco Bay Area Regional Water System Financing Authority and the Bay Area Water Supply and Conservation Agency (BAWSCA). On February 11, 2003, the City Council appointed Vice-Mayor Risch to the Board of Directors for the financing authority. On March 18, 2003, the City Council approved a resolution to create and participate in BAWSCA.

Once fully organized, BAWSCA will act as the agency representing the Suburban Users. Participating in BAWSCA will involve payment of assessments and financing of improvements to the regional water system which will likely include bonding, assessments, and other financing mechanisms. All BAWSCA related costs will directly impact water rates to City customers, but have not been factored into the Resource Allocation Plan as they are yet unknown. Staff anticipates having a better handle on costs for the FY 2004/2005 utility rate setting process.

Additionally, the Long-Term Financial Plan for the Water Fund makes a provision for the long-term cost of infrastructure renovation and replacement for water facilities. It is clear that the water utility will represent one of our largest cost areas for infrastructure projects. The FY 2003/2004 plan includes a more substantial annual transfer for the 20-year planning period beginning in FY 2007/2008. While setting aside these dollars will certainly help, there will be greater long-term requirements that will have to be addressed to fully fund our infrastructure needs.

Finally, the Department of Public Works proposed a number of changes in the Water Supply and Distribution Program as part of the City's budget reduction process. These proposals were made to mitigate the impact of rising costs on utility rates. The reductions totaled $340,849 annually, or approximately 10% of the operating budget not including purchased water costs. These reductions were adopted by the City Council at the April 22, 2003 Utility Rate Hearing and are reflected in the rates established for FY 2003/2004.

The rate increase approved by Council for water utility services for FY 2003/2004 is 10%, compared to the 4.5% anticipated last year. An annual rate increase of 4.0% is anticipated through FY 2008/2009. A 10.6% increase is anticipated for FY 2009/2010 with increases of 4% to 5% for the remaining years of the planning period.

Wastewater Management Fund

The Wastewater Management Fund accounts for the revenues and expenses related to the City-operated sewer collection and Water Pollution Control Plant (WPCP) services.

The Wastewater Management Fund is experiencing the largest increase in personnel costs of the three utilities because personnel is such a large proportion of the Wastewater Management budget. In addition, environmental regulations continue to restrict numerous pollutants, requiring additional study and increased public outreach efforts to reduce the amount of pollutants reaching the San Francisco Bay. Staff is currently undertaking efforts to renew the City's discharge permit under these more stringent requirements. Another impact to the Wastewater Management fund is that permit fees charged to the City by the State have more than doubled with further increases anticipated in the coming year.

Infrastructure maintenance and replacement continues to be a large issue for this fund. The Resource Allocation Plan reflects large infrastructure expenditures on projects that are underway in the early years of the plan. These projects were largely funded by revenues from the Water and Wastewater Revenue Bonds, Series 2001.

Portions of the treatment plant and collection system are approaching 50 years in age. Staff is continuing to identify projects for the future and is working to isolate the cost and life span of various pieces of infrastructure, both at the treatment plant and in the collection system. When identified, projects will be incorporated into a Long-Range Infrastructure Plan. Possible options for financing of the projects will then be explored to ensure that all wastewater collection and treatment processes are maintained in working order. Potential funding sources will be reviewed with the goal of minimizing the impact of infrastructure renovation and replacement on rate payers.

The recommended FY 2003/2004 Budget reflects this need for significant capital improvements. The major infrastructure project is the Borregas Sanitary Trunk Sewer Replacement, budgeted at $5.7 million over a three year period ending FY 2004/2005. Other significant projects include the rehabilitation of Storm Pump Station No. 1 ($2.1 million) and Replacement of the Digester Lids ($1.3 million over seven years).

The recommended FY 2003/2004 Budget also includes a continuing special project that relates to our National Pollutant Discharge Elimination System (NPDES) permit budgeted at $2.3 million over six years, as well as a project to provide for improvements to the processes at the Water Pollution Control Plant ($1.2 million over nine years).

The Wastewater Fund is scheduled to make a substantial contribution of $800,000 per year to the Infrastructure Renovation and Replacement Fund starting in FY 2005/2006. Further increases in the transfers beginning in FY 2011/2012 are anticipated. Unfortunately, it is expected that infrastructure renovation and replacement requirements will be larger in the wastewater area than in any other area because of the WPCP facility. When the Long-Range Infrastructure Plan, which includes all utility funds, is completed, Council will be presented with various alternative ways of developing the necessary funds to support the needed infrastructure improvements.

As part of the City's budget reduction process, Public Works staff proposed cuts in the Wastewater Management Program of $544,258 and new revenue of $67,500, for a total of 5.52% of the operating budget. These reductions were accepted by City Council at the April Utility Rate Hearing and are included in the rates established for FY 2003/2004.

The rate increase approved by Council for Wastewater services for FY 2003/2004 is 7%, an increase from last year's projection of 4.5%. Annual rate increases of 5.0% are anticipated through FY 2008/2009, 4.5% for FY 2009/2010, with 4.0% projected for the remainder of the 20-year planning period.

Solid Waste Management Fund

The Solid Waste Management Fund accounts for the revenues and expenses related to collection, recycling, and disposal of solid waste generated within the City of Sunnyvale. A private company, Bay Counties Waste Services (doing business in Sunnyvale as Specialty Solid Waste & Recycling), has been issued an exclusive franchise for collection of refuse and recyclable materials, and these contract costs are reflected here. Operations of the Sunnyvale Materials Recovery and Transfer Station and disposal of refuse at the Kirby Canyon Landfill are included in a separate fund, but the City's share of these activities is reflected in the Solid Waste Management Fund.

For the second year in a row, the Solid Waste Management Fund was influenced by a reduction in tonnage. Last year there was a corresponding reduction in revenues. This year, that reduction appears to have been mitigated by the rate increase adopted last year.

In the prior 20-Year Plan, it was expected that City of Sunnyvale customers would generate 118,703 tons of solid waste per year (a 7% decrease from prior estimates) which would be delivered to the SMaRT Station. The current plan is updated to reflect recent delivery history and anticipates another substantial (8%) decrease to 108,163 tons in FY 2003/2004. In solid waste collection and disposal, tons traditionally drive both revenue and expenditures. However, the impact on revenues is usually larger than the corresponding decrease in expenditures. This is due mainly to the fixed costs associated with collecting solid waste and maintaining the closed Sunnyvale Landfill. Although this trend is not reflected in the current year, staff is maintaining a conservative approach to projecting revenues.

Overall, the fund is in a good financial position and was able to accelerate payment of a loan to the General Fund, paying off the loan in FY 2022/2023, four years earlier than previously planned.

The rate increase adopted by Council for FY 2003/2004 is 4.0%, half a percent less than planned last year. In order to maintain the Fund in solid financial condition, rates are projected to go up 4.5% annually until FY 2007/2008 and 4% to 4.5% annually for the remainder of the planning period.

Sunnyvale Materials Recovery and Transfer (SMaRT) Station

The Sunnyvale Materials Recovery and Transfer Station Fund consists of two sub-funds. The SMaRT Station Fund accounts for operations at the SMaRT Station and receives its revenue from charges to the cities of Sunnyvale (Solid Waste Management Fund), Mountain View, and Palo Alto. Major operating cost components include the contract with the SMaRT Station operator and disposal fees and taxes collected by the Kirby Canyon Landfill. The fund is designed so that annual revenues and expenditures are in balance and that no fund balance is carried forward to the next year. Operating costs and revenues from the sale of recyclables are charged to or distributed to the cities based on the numbers of tons of solid waste each community brings to the SMaRT Station for materials recovery, transfer, and disposal.

The SMaRT Station Replacement sub-fund provides for the replacement of City-owned SMaRT Station equipment. The three participating cities contribute to these replacement efforts and to payment of debt service based on fixed percentages established by the SMaRT Station Memorandum of Understanding (MOU) among the cities.

In February 2003, the City completed the sale of the City of Sunnyvale Solid Waste Revenue Refunding Bonds, Series 2003. The transaction produced net present value savings of $1,231,530.93, or 6.756% of the par amount of the refunded bonds. The majority of the savings occur in the final year of debt service when the payments are covered by the reserve fund and reserve fund earnings. The savings are distributed to each of the three cities based on their share of the debt service established under the MOU. Sunnyvale will realize approximately $681,000 in savings over the life of the bonds.

The SMaRT Station Fund shows decreases in both revenues and expenditures over the planning period based on updated tonnage projections submitted by all three participating cities. SMaRT operations are affected by the same economic conditions that were discussed earlier in relationship to the City's Solid Waste program. Large swings in tonnage projections are anticipated to be seen in future SMaRT Station Fund Long-Term Financial Plans in response to economic cycles, the independent solid waste management strategies of the three cities, and other factors.

Community Recreation Fund

This fund, which was created eleven years ago, contains the leisure service activities of the City, including the two City-operated golf courses, the tennis center, and recreation classes and services. Prior to the initiation of the Fund, leisure services were part of the General Fund, which routinely contributed more than $2.5 million annually to the effort. The creation of the Community Recreation Fund included the merger of the City's golf and Tennis Center operations with the remainder of all other leisure service activities, as well as the adoption of new, entrepreneurial approaches to service delivery. This approach resulted in a significant reduction in the General Fund subsidy required to support leisure services in Sunnyvale.

Based on early gains, long-term projections were made soon after this Fund was created suggesting that it might be self-sufficient by FY 2000/2001. Careful examination of the assumptions subsequently indicated that some of the revenue estimates could not be achieved, and the Transmittal Letter for FY 1997/1998 acknowledged that self-sufficiency was not realistic for leisure services in the current environment. Given recent Council-approved increases in heavily subsidized service areas (e.g., teen programs), a new Senior Center, and the development of the new 50-meter pool at Fremont High School, this is all the more true today.

Last fiscal year staff also identified the need to reconsider the overall impact of some of the strategies used to achieve this Fund's remarkable financial success. While representing a significant positive effect on the bottom line, the elimination of four management positions within the Division a number of years ago eventually caught up with the Department in terms of its ability to manage both day-to-day operations and non-routine projects.

Another strategy aimed at reducing expenses within the Fund was to rely heavily on the use of "temporary" employees or contract labor for the delivery of recreational services. While a good number of these positions were truly temporary in nature, some were relied upon to deliver on-going services, and deserved to either be classified as regular part-time or full-time City positions.

The recommended FY 2002/2003 Budget addressed both these staffing issues. Related changes resulted in a significant increase in expenditures for the cost of personnel above and beyond those increases due to medical coverage, worker's compensation, and other labor expenses. However, revenue generation in the Community Recreation Fund was also projected to increase significantly and certain operational changes were made to reduce costs.

Golf operations continue to be the greatest single source of revenue for this Fund. A number of new employees are now overseeing related operations, and they have had an immediate and positive effect on both the services we provide our golfers, and the financial position of golf services. The courses have never been in better condition, and satisfaction surveys suggest our golfers are very pleased with playing conditions. Beginning in FY 2001/2002, this Fund reflected a modest improvement in golf revenues, reflecting the City's assumption of golf services formerly provided by Art Wilson Golf Services, Inc. Staff believes, and has demonstrated these past two years, that this transition to City operations will result in improved service as well as an improvement to golf's financial bottom line.

Future year projections of golf revenues take into account the golf industry's trend toward increased numbers of golf courses without corresponding increases in rounds of play. This is a trend we expect to experience as well, with several new courses developed or renovated in this area, and a projected decrease in golf rounds as a result. Everything is relative, of course, and Sunnyvale continues to lead the local courses in terms of golf rounds played.

As indicated earlier, we have increased the amount of the General Fund transfer to the Community Recreation Fund over the 20-year planning period to the amount necessary to support existing service levels. The provision of additional leisure services to the public, unless they are self-supporting, will require either additional General Fund transfers or a reduction in other services.

A fundamental tenet of this Fund, however, is that it can always reduce costs, to the point of becoming self-sufficient at any time by reducing or eliminating services. This is an important concept, and a reassuring one from a worst-case financial planning perspective. Many of the Fund's services to the public are self-sufficient, and would not save the City any money by being eliminated. In fact, some would have just the opposite effect. In addition**,** Council's continued support of market-based golf fees regardless of residency remains a critical factor in maintaining this important revenue stream and supporting other subsidized leisure services.

The dilemma, of course, is that the heavily subsidized services that would need to be eliminated to achieve self-sufficiency are those that are the least attractive to reduce from a public policy perspective (i.e.**,** in terms of community benefit). They are those that serve our youth, senior, disabled and low-income populations.

This has become painfully evident during the City's exploration of ways to solve its current budget crisis. In order to reduce overall expenses associated with the Community Recreation Fund, staff has proposed $208,301 in operating cuts as part of the budget reduction process discussed earlier. A complete list of operating reductions is included in *Volume IV* of the Budget document. Council is also made aware that while no service level reductions are currently proposed for recreational services to the City's seniors, staff is challenged by the proposed Fiscal Year 2003/3004 budget to eliminate the subsidy required by the senior lunch program. If in working with the City's seniors staff finds this challenge can only be met by reducing related service levels, it will return to Council for policy direction and guidance.

For FY 2003/2004, the recommended Budget reflects a General Fund transfer of approximately $3.1 million. This is a $350,000 increase over last year's projection of $2,762,051. A supplemental transfer is also needed through FY 2007/2008, with the total transfer growing to $3.4 million. Over the past several years, reserve funds were used to maintain existing services as an alternative to increasing the General Fund transfer. However, the Community Recreation Fund *20-Year RAP* will be reduced to about $100,000 by the end of FY 2002/2003 and will be maintained as a small emergency reserve for the rest of the planning period. Over the first ten years of the planning period, an additional $1.5 million in General Fund transfer above what was projected last year will be needed to maintain leisure services programming at its current level.

The recommended FY 2003/2004 Budget and Ten-Year Resource Allocation Plan includes no new capital projects in the Community Recreation Fund.

<u>Information Technology Enterprise Fund</u>

As part of Sunnyvale's innovative efforts to streamline building permitting processes, the Information Technology Department developed a permitting software program called SunGIS. Other municipalities expressed a desire to purchase this product, and in FY 1999/2000 the City established the Information Technology Enterprise Fund to represent the revenues and expenditures associated with enhancement and marketing of City-developed software. In September 2000, the City entered into an agreement with Berryman & Henigar Enterprises to allow that firm to market, sell and support software developed by Sunnyvale in return for royalties, software maintenance, enhancements and support. Since the agreement relieves the City of previously anticipated expenditures associated with provision of maintenance, enhancement and support of this system, we have closed this fund at the end of FY 2002/2003 and folded these activities into the Technology Services Sub-fund of the General Services Fund.

SPECIAL REVENUE FUNDS

Special Revenue Funds are used to account for the proceeds of specific revenue sources that are legally restricted to expenditures for specified purposes.

Housing Fund

The Housing Fund is comprised primarily of revenues from federal HOME grants and housing mitigation fund receipts. Expenditures are for capital and special projects targeted to achieve the goals of the City's Housing and Community Revitalization Sub-Element of the General Plan and the 2000-2005 Consolidated Plan. The Consolidated Plan is a five-year comprehensive planning document submitted to the federal government. It identifies a jurisdiction's overall needs for affordable housing and non-housing community development. The federal government requires the City to submit annual updates during the intervening years of the Consolidated Plan, and this is generally done in May of each year.

Housing mitigation funds are maintained in a separate sub-fund, accruing interest solely for housing mitigation purposes as required by law. This fund shows receipts through FY 2004/2005, reflecting only development approved to date; the extended time reflects the payment period approved for Applied Materials in their specific development agreement with the City. The interest income generated in this fund has been programmed for future housing mitigation projects.

In FY 2002/2003, Council appropriated $173,520 for the Housing Assistance for Teachers and City Employees project. In addition, $631,815 for the funds appropriated in FY 2001/2002 was carried forward to FY 2002/2003. The program consists of three components: Homebuyer Education, Security Deposit Loan Program and Down Payment Assistance Program. Staff has proposed an additional $479,771 for this project in the recommended FY 2003/2004 Budget.

Following the proposed appropriations for FY 2003/2004, the Housing Mitigation sub-fund will have a Housing Mitigation Reserve balance of approximately $10.5 million. It should be noted that $1.8 million of this amount was a Below Market Rate (BMR) in-lieu fee contributed by Haseko Residential Inc. for the Lawrence/101 development project in 1991. In FY 2003/2004, staff will be working to segregate the BMR in-lieu fee with accrued interest to ensure that it is properly used for BMR related activities.

HOME funds are also maintained in a separate sub-fund of the Housing Fund. The City has been notified that its allocation of these monies for FY 2003/2004 totals $777,829. Including program income received to date, $1,094,414 is being recommended in FY 2003/2004 for the following activities: Preserve at Risk Housing ($727,740), Acquisition/New Construction ($250,000), and CHDO Set Aside ($116,674.) These projects target the goals of the City's General Plan and the 2000-2005 Consolidated Plan.

Finally, the Housing Fund has a third small sub-fund that contains other grant-supported housing activities. Revenues in this sub-fund include housing monitoring fees and revenues from BMR code violations. Expenditures are primarily operating costs associated with maintenance and monitoring of the BMR program. An on-going special project in this sub-fund provides for the auditing of BMR participants to ensure compliance with program regulations.

Community Development Block Grant Fund

The Community Development Block Grant Fund is comprised of revenues from Community Development Block Grants, rental income from the City's Manzanita property, and the repayment of commercial and residential loans. Primary expenditures are for housing opportunities, special projects, and most of the City's outside group funding efforts.

On the revenue side, Community Development Block Grants are shown through FY 2003/2004. The Federal Government has notified the City of its FY 2003/2004 entitlement. Similar to the long-standing strategy used with all federally financed programs, future grant receipts are not shown beyond the immediate planning horizon. When and if these entitlements are no longer provided, expenditure levels would drop considerably. At that time, Council would have to make determinations as to where the priorities will be regarding the relatively small amount of income that would continue to be available on an annual basis from loan repayments.

CDBG funds are used primarily to address the City's affordable housing strategy. This includes support of housing and human service agencies; rehabilitation and retrofitting of the existing housing stock; and the acquisition, rehabilitation, and construction of affordable housing by non-profit developers. As in the Housing Fund, capital and special projects are targeted to achieve the goals of the City's Housing and Community Revitalization Sub-Element of the General Plan and the 2000-2005 Consolidated Plan. In addition, CDBG funds may be used for programs or projects that benefit groups with special needs such as senior and handicapped citizens.

For FY 2002/2003, funds in the amount of $300,000 were appropriated for construction of the Sunnyvale Senior Center. These funds were in addition to the $1.7 million previously allocated from CDBG, bringing the total to $2 million. For FY 2003/2004, the Housing and Human Services Commission has recommended $299,000 in support of the programs of 15 non-profit social service agencies. Funds will also be allocated for a wide variety of housing and housing related activities, including the acquisition/development of new affordable housing units, rehabilitation of existing and affordable housing units, lead-based paint abatement, the removal of architectural barriers, and fair housing services.

Park Dedication Fund

The Park Dedication Fund was established to meet statutory requirements regarding the accounting for park dedication monies. In general, the City collects park in-lieu fees for multi-family residential projects that do not dedicate land for use as parks or open space. Those revenues are recognized in the Park Dedication Fund, and then available resources are transferred to the Capital Projects Funds for designated and approved park-related projects. Revenues in this Fund also include rental income from certain houses that the City purchased with Park Dedication Funds in anticipation of park expansion projects.

Some years ago, the methodology for determining park in-lieu fees included a determination of fair market value on a project by project basis. This process was sometimes contentious and time-consuming for both the project proponent and staff. In 2000, Council approved an alternative methodology for determining park in-lieu fees that eliminated the need to determine fair market value on a project by project basis.

In past years, this fund was earmarked to help cover the costs of approved park-related projects. Projects have included both the renovation of existing parks and the addition of new parks. The City has never relied on this fund in order to plan its open space projects. In other words, park projects have been planned on the basis of community need as opposed to the amount of funding available in the Park Dedication Fund. In fact, the General Fund has funded the vast majority of past park projects, with the Park Dedication Fund simply an additional funding mechanism to periodically offset costs planned in the General Fund.

In FY 1999/2000 the City received over $1.4 million in park dedication fees in relation to three large residential projects (the Irvine Apartments on the Olson property, the Villa del Sol apartments at Sunnyvale and Evelyn Avenues, and the Las Palmas homes on the Stowell property). No park dedication funds have been received since that time. Opportunities for the type of large residential activity that occurred in FY 1999/2000 are limited, and so projections for future years have been not been made. The concept is that the City cannot count on, nor predict, this revenue stream. Therefore, appropriations will only follow the actual receipt of park dedication fees. This will be done in the context of the budget process.

The largest single appropriation of Park Dedication Funds has been for the design and construction of a new Downtown Plaza Park at Evelyn Avenue and Frances Street. Funds have been made by way of a transfer to the Capital Projects Fund, which is accounting for the Downtown Plaza project. Discussion of this project and progress to date is included in the *Major Project Efforts* section of this Transmittal Letter.

Two additional projects were funded with the use of Park Dedication funds in the recommended FY 2001/2002 Budget. These included the construction of the Fair Oaks Skateboard Park and the expansion of Ortega Park's playground. For FY 2002/2003, $95,750 was approved for the expansion of Murphy Park. These dollars represented a placeholder for a larger project that included land acquisition and construction. During the capital project reevaluation process associated with the 6-

Point Plan, the Murphy Park project was defunded, leaving $10,000 to cover design costs spent to date.

At the end of this current fiscal year, the City will have $447,548 remaining in this fund's reserves after appropriations have been made for the projects mentioned above. These uncommitted funds may be needed for existing park projects that cost more than planned or possible use for the Sunnyvale Historical Museum. Absent this need, use of these funds would be considered in the next two-year projects budget process.

Asset Forfeiture Fund

The Asset Forfeiture Fund was established to account for monies received through drug and other law enforcement activities as allowed under Federal and State asset forfeiture guidelines. Because the purposes for which asset forfeiture can be used are limited, the strategy currently employed and recommended for future years is one that would draw down funds for new one-time expenses targeted for law enforcement services. The objective over time would be to draw down all of the resources in this fund. By the same token, caution should be used to assure that these expenses are ones that fit into the City's priorities.

One small operating expense is included in this Fund to cover allowable ongoing costs related to the yearly asset forfeiture audit.

For the recommended FY 2003/2004 Budget and Ten-Year Resource Allocation Plan, one special project is included for funding:

- **Evidence Barcode Tracking System**: This project provides $54,586 to purchase and install a system to ensure accurate tracking, maintenance, destruction, return and record keeping of property and evidence seizure. This project will allow the City to provide evidence tracking services that are consistent with professional guidelines, improve liability management, and meet legal requirements.

In addition to the special project listed above, one transfer from this fund to the General Services Fund is budgeted in FY 2003/2004. This transfer is for the Police Services portion of a project to upgrade the City's network infrastructure. This project capitalizes on the existing fiber backbone of the City's network and builds a more robust infrastructure with built-in redundancy and fail-over capabilities. The new infrastructure would increase network traffic speeds by at least ten times to improve network response times and strengthen network security. This project is funded by a 15% contribution from Asset Forfeiture Fund, and 85% contribution from General Fund.

The continuing transfer to General Fund from the Asset Forfeiture Fund is to support juvenile diversion activities within Police Services.

Police Services Augmentation Fund

The Police Services Augmentation Fund is closely related to the Asset Forfeiture Fund. This fund accounts for two grant programs that provide monies for law enforcement purposes. The first is the Supplemental Law Enforcement Services (SLES) program established by the State, and the second is a small Federal block grant from the Bureau of Justice Administration (BJA). For FY 2002/2003, both of these grants were used to fund two Lieutenant positions in the Bureau of Professional Standards in the Public Safety Department. In addition, SLES funds provided for the continuation of a Police Patrol Team Captain position.

State and Federal law requires that SLES/LLEBG funds be spent by the end of the fiscal year subsequent to the fiscal year in which they were received. The City is in compliance with this requirement. The transfer from the General Fund to this fund represents the City's matching requirements for the BJA block grant.

The financial plan for the Police Services Augmentation Fund reflects revenue only through FY 2003/2004 in keeping with our policies of not recognizing speculative grant revenues. Although the State SLES funds have been targeted as a possible reduction in funding to local governments, as of this writing they are still in the State budget. It is important to note that reserves in the Fund will be depleted by the end of FY 2002/2003. Funds for operations will therefore be substantially reduced.

Employment Development Fund

The City of Sunnyvale, as administrative entity for the North Valley (NOVA) Job Training Consortium, is required by legislation and regulations to account for the use of various Federal and State funds and program revenues for the workforce development activities that are conducted for the consortium. The City has established the Employment Development Fund to fulfill this obligation.

NOVA, formed in 1983, serves the cities of Cupertino, Los Altos, Milpitas, Mountain View, Palo Alto, Santa Clara and Sunnyvale, and is administered by the Department of Employment Development of the City of Sunnyvale. NOVA programs receive no General Fund resources. NOVA has a wide variety of programs funded through various vehicles, with baseline funding originating from the Federal government and passing through the State of California. A significant amount of additional grant money is received from Federal and State sources, as well as the County of Santa Clara, local companies and foundations. Since July 1, 2000 the primary funding for the Department of Employment Development/NOVA has been allocated through the Workforce Investment Act (WIA). While WIA-allocated funds are still a key portion of its budget, NOVA has significantly decreased its reliance on these funds over the past four years through the intentional diversification of funding sources (78% of the budget in FY 1999/2000, 67% in FY 2002/2003).

The WIA-allocated funds for NOVA for FY 2003/2004 have just been released by the State of California. Even though the State of California received a reduced allocation from the Federal government of $90 million (16%), NOVA's allocation doubled to $3,793,514 reflecting the significant increase in the demand for re-employment services in our region. In addition to these allocated funds, NOVA has a long history of being very competitive for additional Federal and State resources to address the ever-changing workforce development needs of the region. For example, in FY 2002/2003 NOVA applied for and received an $8 million grant to help dislocated workers gain new training and employment.

For the purposes of the City's recommended FY 2003/2004 Budget, we have taken the funds that were available in FY 2002/2003 and used these as a starting point for NOVA's FY 2003/2004 programs and service levels. It is important to note that the Department has not yet migrated to the outcome management format. As different grants come and go, various programs and activities have a relatively short lifespan relative to other City departments. Therefore, the current listing of programs that have operated during the last several years are not included in this recommended Budget. Rather, a base funding level will be carried into the new fiscal year and the City Budget will be modified for planned activities, outcomes and expenditures during the course of the year as new funding is secured.

As in the past and in keeping with the City policy for grant-funded programs, the Employment Development Fund Long-Term Financial Plan reflects grant revenues only for the immediate planning period.

Parking District Fund

The Parking District Fund is a small fund that provides for the ongoing maintenance of downtown parking lots as well as the retirement of outstanding debt obligations utilized to purchase land and make improvements. This Fund's revenue sources are special assessments and property taxes.

The Downtown Parking District includes all public parking in the downtown area with the exception of the parking structure adjacent to the Sunnyvale Town Center, which is under ownership of the Redevelopment Agency and leased to the shopping mall.

The approval of Proposition 218 had a significant effect on the methodologies utilized to raise assessments to fund maintenance and operations within the Parking District. Proposition 218 not only deals with the approach and methodologies to be used for benefit assessments, but also the approval process. Essentially, after a method has been selected, a vote occurs by those who would be assessed, with votes weighted according to the amount of assessment. If this weighted majority does not approve the assessment, then it does not go forward. The only exception is for outstanding bonded indebtedness that the City has a continued right to collect. Annual debt service is approximately $70,000, with the final payment to be paid on July 1, 2003. Annual debt service has been funded by ad valorem property taxes.

Beginning in FY 1998/1999, voters in the District approved the new assessment methodology and have assessed themselves annually for operation and maintenance. In 2002/2003, property owners approved a two-year assessment that extends through FY 2003/2004. It should be noted that Parking District Fund reserves will be totally depleted in FY 2003/2004.

The various new developments now occurring or planned in the downtown area are likely to change the character of the parking assessment district, making it extremely difficult at this time to project expenses and revenues into the future. Therefore, the Parking District Fund Long-Term Financial Plan shows that the assessment revenue remains the same, with a slight inflationary factor over the remainder of the planning period. Once the existing *20 year RAP Reserve* funds are exhausted in FY 2003/2004, operational expenses are shown as decreasing to equal special assessments. It should be noted that once all of the various factors related to parking in the downtown are defined and stabilized, the Parking District may be reconfigured considerably.

One other issue concerning the Downtown Parking District is the continuing threat that the voters will not approve the assessments at some point in time. It is likely that those who framed Proposition 218 did not consider its impact in situations such as this. Downtown merchants rely on this parking, and obtained authorization to operate their businesses based upon the availability of shared parking. Most have no private parking available. Nonetheless, during FY 2002/2003 the property owners did not initially approve of the assessment. A full study of options was then done in conjunction with the downtown merchants and, as a result, a second election was held that approved the assessment for two years. If, however, the assessment is not approved any time in the future, funds will not be available for continued operation of the District. In such an event, the question would be how the City would fund the District. There is no question that the cost to the merchants for publicly provided parking is far below that which would have been the case had they had to acquire the necessary land, make the required improvements, maintain the improvements, and pay property taxes on the improvements. These are costs that anywhere else in the City the private sector must bear without public assistance. It would therefore be necessary for staff to explore other potential revenue raising possibilities in the event that the assessment would not be approved. Certainly one of the alternatives is paid parking.

Finally, the Parking District Fund completed a major capital project in FY 2002/2003. This project provided for construction of a 250-space underground public parking facility in a structure beneath the future Downtown Plaza Park. The facility, constructed in conjunction with the Mozart Development Corporation project in Downtown, was completed and opened to the public in July 2002.

Youth and Neighborhood Services Fund

The Youth and Neighborhood Services Fund accounts for the revenues and ongoing operating program expenditures associated with the management and maintenance of the Columbia Neighborhood Center. The Columbia Neighborhood Center was developed to meet the health, social, recreational, and education needs of North Sunnyvale residents through a coordinated network of services. The development of the Columbia Neighborhood Center was a collaborative effort between the City, the Sunnyvale School District, Advanced Micro Devices, and numerous community agencies that began in the fall of 1994. In FY 1996/1997, Council invested $500,000 as seed funding for the development of the Columbia Neighborhood Center. This was essentially the City's share of the Advanced Micro Devices contribution to Columbia Neighborhood Center. When this Fund was established, it carried with it a commitment to maintain this $500,000 to generate interest to help offset ongoing operating program expenditures. Also included in the ongoing fund balance were contributions made to the City in the amount of $6,658 on behalf of former employees which bring the current endowment total to $506,658.

At this time, only the operating program expenditures and Columbia Neighborhood Center related projects are in this fund along with the associated program revenues. As outlined in the partnership agreement with the Sunnyvale School District, a portion of the operating program expenditures are reimbursed for the youth services provided at the Columbia Middle School site.

In FY 2001/2002 and FY 2002/2003 funds totaling $397,726 were appropriated for a capital project to expand the Columbia Neighborhood Center Facility. The project was dependent upon external support, largely in the form of participation by the Sunnyvale School District. The difficult financial situations of both the City and the District have made continuing with the expansion inadvisable at this time, and therefore the funding for this project was eliminated during the recent budget reduction process. Additionally, the Columbia annual operating budget has been reduced by $16,165 in FY 2003/2004 to reflect the budget reduction proposals for this Fund.

Redevelopment Agency Fund

The Redevelopment Agency is a separate governmental and legal entity from the City. However, the Agency is a component unit of the City for which the City is financially responsible. Further, due to certain agreements between the Redevelopment Agency and the City, the General Fund of the City is inextricably tied to the financial condition of the Redevelopment Agency. As a result, the Redevelopment Agency Fund is traditionally covered as a part of this Transmittal Letter.

At the close of FY 2001/2002 the Redevelopment Agency had an outstanding loan due to the City General Fund of approximately $42.5 million. This is largely the result of the Redevelopment Agency's inability to raise sufficient tax increment revenue to repay the City for annual lease payments made by the City for the downtown parking structure. The original financial plan established by the City Council in the mid-1970s was turned upside down with the passage of Proposition 13, which stripped the agency of approximately two-thirds of its property tax increment. Since that time, the State has enacted several laws that placed further restrictions on redevelopment agencies. These include capping the time period for collection of tax increment for each redevelopment project area; for Sunnyvale's project area, the cap year is currently 2025. More important was the establishment of revenue limits for redevelopment agencies, referred to as property tax increment caps. The revenue limit/increment cap for the Sunnyvale Redevelopment Agency is $118 million, effectively making it impossible for the City to ever fully recover its loan.

When tax increment revenues from the downtown area as it originally existed were projected, the Agency reached its increment limit just before the time limit was reached in 2025. However, the recommended FY 2003/2004 Budget now reflects the completion of the 460,000 square foot Mozart office project and the placing of new tax increment from this source on the property tax rolls over a two year period. As a result of including the increased taxes from the Mozart project, the property tax increment limit of $118 million is reached in FY 2021/2022.

Given the completion of the Mozart project, the nature of the Redevelopment Agency Fund Long-Term Financial Plan has changed. First, the increased speed at which we reach our limit requires that we set aside funds for the Agency's debt obligations which are due after FY 2021/2022 when tax increment stops. This is done by assuring adequate balances in the *20 Year RAP Reserve* until the last year of debt service payments (FY 2022/2023). Second, the expenditure line item *Downtown Increased*

Tax Benefit reflects additional tax increment revenue that can be used by the Agency beginning in FY 2009/2010. Any increase to property tax revenues in the downtown can be used for two purposes beyond payment of debt service: repayment to the City on the outstanding loan or downtown projects. For the financial plan the repayment to the City was held constant at the level previously planned, and the debt service payments were maintained for the required time period. The *20 Year RAP Reserve* was then balanced to zero in FY 2022/2023 to reflect the completion of the Fund's debt service obligations, with any remaining funds shown in the *Downtown Increased Tax Benefit* expenditure line item on a level annual basis. As stated, this line item reflects the potential additional tax increment funds that the City has available for downtown projects or repayment to the City.

Operations for the Redevelopment Agency consist primarily of activities in the Economic Prosperity program managed by the Community Development Department. The budget reduction process recently concluded resulted in $106,400 in consulting and marketing expenses being reduced from the operating budget for this program beginning in FY 2004/2005. It should also be noted that the Agency's Long-Term Financial Plan reflects the fact that tax increment will no longer be available to support Agency operations beginning in FY 2022/2023 after the tax increment cap is reached. As that time nears, the City will need to consider how to fund ongoing Economic Prosperity operations and at what level they should be sustained.

In FY 2001/2002 Council approved a capital project for improvements to the Downtown area, to be funded by an advance of $1.5 million from the General Fund to the Redevelopment Agency Fund. The advance was based on the expectation of the new tax increment from the Mozart project, which would allow us to realize additional funds for the project area. The current financial plan shows a repayment of this advance over a four-year period beginning in FY 2005/2006. Following that repayment, the Downtown Increased Tax Benefit line-item begins at approximately $500,000 annually, as previously described.

Expenditure of the capital project for downtown improvements has now been anticipated through FY 2004/2005.

It is important to note that no further development activity has yet been anticipated in the financial plan. To the extent that the Town Center Mall is redeveloped and development occurs on the north of Washington block, more tax increment will be produced for the Agency, which will cause the City to reach its revenue limit earlier. To address the issue of the property tax increment cap, the City is currently in the process of evaluating the feasibility of amending the Redevelopment Plan to increase the revenue limit.

For FY 2003/2004, the Redevelopment Agency is projected to make a repayment to the City in the amount of $1,030,894. No new special or capital projects have been programmed in the Redevelopment Agency Fund.

It is important to emphasize that in spite of the outstanding General Fund loan, the downtown redevelopment project instituted by the City in the mid-1970s has more than paid for itself. This is because any new incremental Sales Tax generated goes directly to the General Fund but is not credited against the outstanding loan. If credit were given for the Sales Tax increment, even at its current level, there would be no outstanding loan.

<u>Patent Library Fund</u>

Sunnyvale Public Library has served the needs of the intellectual property community for nearly 40 years. In the mid 1990s, the City and the United States Patent and Trademark Office (USPTO) formed a partnership which elevated the level of service available in Sunnyvale to nearly equal that of the office in Washington, D.C. The partnership, Sunnyvale Center for Innovation, Invention and Ideas Sc[i]^3, is the flagship of the Patent and Trademark Depository Library Partnerships which also includes a center in the Detroit Public Library. A third partnership, replacing one that closed at Rice University, recently opened at Texas A & M.

Sc[i]^3 is recognized as an important contribution that the City of Sunnyvale makes to the economic development in the region. Services and products designed and tailored to the needs of Silicon Valley inventors, intellectual property attorneys, corporate legal staff, researchers, patent agents and paralegal staff have been offered through Sc[i]^3 for the past seven years. Several years ago the availability of patent and trademark information on the Internet began to undermine some of these services, and the patent library revenue stream has been negatively affected. Efforts to enhance revenue through other means such as the Friends of Sc[i]^3 Foundation or through support from the State of California have proven unsuccessful.

Sc[i]^3 was redesigned and relocated to the main library in January 2002. Fiscal Year 2002/2003 has been the first full year of operation with a streamlined budget and reduced services under which Sc[i]^3 is expected to be fully self supporting. The operation is very lean with a very small staff. Some of the services offered are able to cover their own cost entirely while others operate without full cost recovery. The program is constrained from covering all costs in some cases because the federal government sets the fees. Several other factors contribute to the fact that Sc[i]^3 has a difficult time reaching full self sufficiency.

First, Sc[i]^3 is required to pay a subscription fee of $30,000 to the USPTO. Without the fee the operation would be fully covering its own costs and have a small amount of money available to develop new courses or conduct public relations activities. Having paid the fee for the year, Sc[i]^3 expenses exceeded revenue by $22,960 as of year-to-date. Repeated efforts to have this fee eliminated have been unsuccessful. Second, customer input has taught us that our most valuable role is that of liaison to the USPTO. Our customers value the opportunities the partnership has provided in the past to meet with PTO officials at Sc[i]^3 events. In recent years this role has been virtually eliminated because the visits of patent and trademark officials to this area are not coordinated with Sc[i]^3 and Sc[i]^3 is not notified in advance of these visits. This seriously undermines our credibility with our customers and also leads to lost opportunities for fundraising or revenue generation. This year, due to other travel obligations, patent officials are unable to participate in a major seminar which would have helped correct our budget deficit.

For these reasons, there is some risk with continuing the operation of Sc[i]^3 . Staff cannot guarantee that the operation can be self-sufficient as long as the subscription fee is in place, nor can we any longer predict certain revenues without the support of the USPTO for an annual major seminar and visits to California. Finally, a logical long-term goal of the USPTO is to make all its resources available electronically. At some point in time further advances in this area could undermine the remaining fee based services provided by Sc[i][3].

Transportation Development Act (TDA) Fund

For FY 2003/2004 a new, small special revenue fund has been established to account for activities related to the Transportation Development Act (TDA) funds received from the State of California through the Metropolitan Transportation Commission. These funds are restricted for pedestrian and bicycle facilities and bicycle safety education programs and must be segregated for those purposes. In the past these funds were accounted for in the Gas Tax Fund. Although many of the projects using TDA monies are multi-funded by Gas Tax, TDA and other funding sources, they are completely different sources of funds and should not be reported in the same fund. In addition, the TDA, in accordance with Public Utilities Code Section 99245, must submit a report of a fiscal and compliance audit made by an independent auditor at the end of each fiscal year. In order to facilitate the audit and the issuance of the fiscal and compliance report, the City decided to segregate this fund into its own special revenue fund.

CAPITAL PROJECT FUNDS

Capital Projects Funds are used for major capital acquisition, construction activities, and renovation or replacement of fixed assets. The City currently operates two of these funds: the Capital Projects Fund and the Infrastructure Renovation and Replacement Fund.

Capital Projects Fund

The Capital Projects Fund was established in FY 1997/1998 to account for capital projects that are funded by the General Fund and other governmental funds or that are funded by multiple sources. The Capital Projects Fund is divided into distinct sub-funds that receive direct transfers from the funds that are responsible for the particular projects. Each sub-fund records revenues, interest earnings, transfers and expenses separately. There are currently seven sub-funds: the General sub-fund, the Wastewater Management sub-fund, the Water sub-fund, the Gas Tax sub-fund, the Measure B sub-fund, the Traffic Mitigation sub-fund, and the Multi-funded sub-fund. As we move toward our goal of reporting and accounting for all applicable City capital-related activities in this fund, it has become apparent that this fund will continue to grow.

Major project efforts included in the Capital Projects Fund are discussed throughout this Transmittal Letter under their applicable funding source. The table below is an overview of project expenditures by sub-fund for FY 2003/2004.

Capital Projects Fund - Project Expenditures by Sub-fund	
Sub-fund	FY 2003/2004 Recommended Budget
General Fund Assets	$ 500,000
Wastewater Management	406,980
Gas Tax	1,150,000
TOTAL	**$ 2,056,980**

The effect of the budget reduction process on the Capital Projects Fund is highlighted below:

- In the FY 2002/2003 *Current Requirements* section of the financial plan, a total reduction of $7,438,599 is recommended by the City Manager. This includes $6,538,599 of reductions to various projects contained in the Capital Projects Fund and a $900,000 reduction to the transfer requirements among the various Sub-funds as a result of the budget reduction process.

- In the *Current Resources* section of the financial plan, a total reduction of $5,392,280 is recommended by the City Manager in FY 2002/2003. This represents the reduction to transfer-in revenues, which are designated for projects that have been recommended for defunding and/or funding with reduced budgets.

- In FY 2003/2004 and beyond, the effect of the budget reduction process is a net decrease of $2,226,906 in the projects budget, when compared to the FY 2002/2003 Adopted Budget.

Details of the project reductions are included in *Volume IV Recommended Reductions* under the Recommended Projects Plan tab.

Infrastructure Renovation and Replacement Fund

The Infrastructure Renovation and Replacement Fund was introduced with the FY 1996/1997 Budget and Ten-Year Resource Allocation Plan. Its importance has grown with each subsequent year as staff identifies projects to address the City's need to fund the renovation and replacement of its extensive physical infrastructure. This growth will continue until staff completes the Long-Range Infrastructure Plan (LRIP).

Similar to the Capital Projects Fund, this fund is divided into distinct sub-funds that receive direct transfers from the funds that are responsible for the particular infrastructure projects. Each sub-fund records revenues, interest earnings, transfers and expenses separately. The sub-funds are General, Wastewater, Water, Solid Waste, Community Recreation, and General Services.

Major projects contained in this fund are described throughout the Transmittal Letter. The following table contains project expenditures by sub-fund for FY 2003/2004.

Infrastructure Fund – Project Expenditures by Sub-fund	
Sub-fund	FY 2003/2004 Recommended Budget
General Fund Assets	$4,730,254
Wastewater Management	4,508,967
Water Distribution	1,586,234
Community Recreation	110,108
General Services	61,860
Multi-Funded Assets	35,700
TOTAL	**$11,033,123**

It should be noted that information on each of the projects is available in the *Volume II Projects Budget*.

The effect of the budget reduction process on the Infrastructure Fund is highlighted below:

- In the FY 2002/2003 *Current Requirements* section of the financial plan, a total reduction of $173,571 is recommended by the City Manager. This includes reductions to various projects that are recommended to be defunded and/or funded with reduced budgets.

- In FY 2003/2004 and beyond, the effect of the budget reduction process is a net decrease of $1,407,626 over the Ten-Year planning period.

INTERNAL SERVICE FUNDS

The City utilizes internal service funds to account for the financing of goods and services provided by one department or agency to other departments or agencies of the City. There are two such funds that operate on a cost reimbursement basis: the General Services Fund and the Employee Benefits and Insurance Fund. Both of these funds play an important role in the overall ability of the City to conduct business. Sunnyvale's full cost accounting methodology results in all of the costs of these funds being charged back to user activities on a rental rate or additive rate basis. Therefore, the total expenditures of these two funds are not added to the overall budget.

Beginning in FY 2002/2003, the City created two additional internal service funds. One of the new funds accounts for activities associated with the Sunnyvale Office Center, an office complex located at 505 W. Olive purchased in FY 2001/2002 to provide potential expansion opportunities for the Civic Center complex. The other new fund was created to separate property and liability insurance costs from the Employee Benefits and Insurance Fund.

General Services Fund

The General Services Fund provides a wide range of important support services to programs within the City. These services range from fleet, to building maintenance, to technology and communication services. Funding for these services is recovered through rental rates charged to benefiting program operating budgets. The rental rates may include not only the cost of operations, but also the cost of replacement for depreciable equipment. This assures the availability of funds to replace equipment at the most cost-effective time.

There are a number of sub-funds within the General Services Fund in order to recognize distinct support service functions and establish appropriate rental rates for each. These include:

- **Fleet Services:** The Fleet Services program reflects the cost of ownership of City vehicles and equipment. A primary objective of Fleet Services is to provide rental rates that are competitive with those offered in the private sector.

- **Facilities Management Services:** The Facilities Management program reflects the cost of maintaining City facilities, free standing furniture, modular furniture, and building equipment.

- **Technology Services:** The Technology Services program reflects the cost of ownership of the City's computing equipment. Eight factors contribute to the total user charge: central computer maintenance, desktop maintenance, software maintenance, training, development of equipment specifications and/or applications, project maintenance, administrative and support services, and equipment replacement costs.

- **Communication Services:** The Communication Services program reflects the cost of ownership of City communication and office equipment. Five equipment categories are included: communication equipment, office equipment, mail services, print shop services, and telecommunication franchise (all KSUN related equipment).

- **Sewer Equipment:** The Sewer General Services program has responsibility for all equipment at the Water Pollution Control Plant and all equipment for the wastewater collection system. These rental rates are applied exclusively to the Wastewater Management Fund.

- **Public Safety Equipment:** The Public Safety Department has responsibility for the General Services program that manages all fire and police service equipment. All rental rates are applied exclusively to the General Fund.

- **Parks and Recreation Equipment:** The Parks and Recreation Department has responsibility for the General Services program that manages all leisure services equipment. All rental rates are applied exclusively to the Community Recreation Fund.

Aggregate rental rate increases for General Services Fund activities are projected at

3.68% for FY 2003/2004 and an average of 3.07% over the remaining years of the financial plan. Rental rates are lower in the second ten years of the plan. Overall, rental rates are substantially lower than those projected last year.

As part of the City Manager's 6-Point Action Plan, staff analyzed rental rates associated with fleet, building, technology, and communication services. Rental rates include two key components: equipment costs and operating costs (i.e. personnel, materials, consumables, and other types of operating expenses.) Rental rates are used to allocate the costs for these services among all benefiting City funds. Staff re-examined the assumptions, models, and schedules used in preparing the rental rates. The revised rental rates will generate annual savings of about $500,000 in equipment charges/in-lieu fees allocated to other City departments. In addition, the revised rates will generate $1,426,987 in operating expense savings for the Public Works, Parks and Recreation, and Information Technology departments that manage rental rate programs. These savings have been passed on to the user departments. For more information, please see the *Rental Rates and In-Lieu Fees/Inter-Fund Transfers Report* in *Volume IV.*

Employee Benefits and Insurance Fund

The Employee Benefits and Insurance Fund receives its revenue from direct service programs by way of additive rates applied to staff salaries. Expenditures are for payment of pension costs, employee insurance plans, workers' compensation costs, and all leave time including accrual of outstanding leave benefits. To better track and analyze expenditures, the Fund was separated into four sub-funds for FY 2002/2003. The four sub-funds are: Leaves and Benefits, Retirement Benefits, Workers' Compensation and Insurance and Other Benefits. Liability and property insurance and administration, previously a part of the Employee Benefits and Insurance Fund, has been broken out into its own fund because these costs are not related to salary expenditures, but rather are recovered on claims experience and building space usage.

Incorporated into the recommended FY 2003/2004 Budget and Long-Term Financial Plan are significant increases in employee benefit costs. For FY 2003/2004 total expenditures in the combined fund are up by $5.4 million over the current budget. The major causes of this increase are:

- **PERS Costs:** Sunnyvale contributes to two California Public Employees Retirement System (CalPERS) plans for and on behalf of its employees: Safety (3% @ 50 Plan) and Miscellaneous (2% @ 55 Plan). Rates provided by CalPERS for FY 2003/2004 are shown below:

CalPERS Plan	Employee Rate	Employer Rate
Safety (3% @ 50)	11.25%	16.875%
Miscellaneous (2% @ 55)	7.00%	0.577%

  These rates are applied against employee salaries (PERSable earnings) in order to calculate the dollar amounts the City must contribute. The City is responsible for both the employer and employee share.

It is important to note that these rates were set by CalPERS using actuarial analysis that is two years old. In the last two years, substantial losses in the CalPERS investment portfolio have occurred, resulting from the dramatic decline in the stock market. The actuarial valuation that the current rates are based on is for the period ending June 30, 2001. Underlying actuarial assumptions from CalPERS are that earnings will be 8¼% annually. In FY 2000/2001, the CalPERS portfolio experienced a real 7% decline in earnings, for a net negative position of 15¼%. In FY 200l/2002, the real decline in earnings was about 6%.

The rates provided by CalPERS actuarial staff for FY 2003/2004 include only the first year (FY 2000/2001) of investment loss. CalPERS has also provided an estimate of our rates for a second year (FY 2004/2005). The estimated rate for the Miscellaneous plan is 5.5% and for the Public Safety plan is 28.6%. Staff has reviewed the estimates with our consulting actuary from Aon Consulting, who adjusted the Miscellaneous plan rate to 6.6% for FY 2004/2005 to reflect the fact that the City's base wages are substantially higher than those projected by CalPERS. Staff has incorporated the FY 2003/2004 and FY 2004/2005 rate estimates into the Long-Term Financial Plan for this sub-fund and continued them at that level for the remainder of the planning period.

Significant investment losses are still being experienced by CalPERS during this fiscal year. As of March 31, 2003, the portfolio was experiencing a 6.86% real decline. The March results, however, are improved over that of prior months. If investment losses continue for an historic third year, it will mean further rate increases in FY 2005/2006 for all jurisdictions including Sunnyvale. These additional increases have not been included in the Long-Term Financial Plan.

The effect of marked increases in CalPERS rates has been particularly noticeable in Public Safety additive rates. The change in the Public Safety plan from 2% @ 50 to 3% @ 50 in FY 2000/2001 represented a 50% increase in the value of the retirement benefits for Public Safety members. This enhancement was made possible in large measure by the large surplus assets in the Public Safety plan, and an agreement between the City and the Public Safety Officers Association was made to split the estimated additional cost of the retirement enhancement equally between the City and the Association. The current and projected extraordinary losses in CalPERS assets have resulted in significant increases in public safety retirement costs and in the cost of the 3% @ 50 benefit. By FY 2004/2005 the additive rate for sworn personnel will be almost 100% of direct wages because of the higher CalPERS rates. This rate could increase even further in the following years because of the CalPERS investment losses.

- **Medical Insurance:** Staff has continued to monitor the rising costs of medical insurance and the impact to the City. Discussions last year with the CalPERS Health Benefits Services Division staff indicated that calendar year 2003 rates would experience an increase in the 20- 25% range. This projection has proven accurate. CalPERS staff also anticipated increases in the low teens for the next three to four years, with high single digit increases for the foreseeable future. To incorporate these estimates into the Long-Term Financial Plan, staff increased the cost of medical insurance by 13% for FY 2002/2003 and 15% for FY 2003/2004, and reflected the projections mentioned above for the first ten years of the planning period. These significant increases add to the troubling trend of personnel costs rising much more rapidly than revenues that was discussed in the *Future Fiscal Issues* section of the Transmittal Letter. Unfortunately, there appear to be no easy solutions for cost containment at this time.

- **Workers' Compensation Claims:** In past years, the budget for workers' compensation claims has utilized an historical average. However, with the rapidly increasing costs of claims, it became clear that the average was no longer effective in setting rates. Therefore, the FY 2002/2003 budget reflected the actual cost of claims and resulted in an increase of more than 40% over the prior year. During this current year I convened an interdepartmental task force to develop and implement steps to moderate and contain workers' compensation claims and a report on best practices was completed in March. To reflect staff's efforts to contain and moderate these costs, the Long-Term Financial Plan does not continue the sharp ascent in costs, but rather, forecasts more incremental cost increases in the later years.

Reserves in the Employee Benefits and Insurance Fund have been set at amounts recently established by actuarial studies. The reserve levels are expected to be as follows:

Reserve Item	FY 2002/2003 Year-End Amount
Workers' Compensation	$ 14,063,020
Vacation Leave	6,879,539
Post Employment Medical Benefits	12,651,191
PERS Retirement Benefits	1,151,881
Liability and Property*	1,129,960
Total Employee Benefits Fund Reserves	**$ 35,875,591**

*Liability and Property were separated into a new fund for FY 2002/2003.

Staff continues to commission actuarial studies to set the reserve levels in liability, workers' compensation and post employment medical benefits. The vacation leave reserve and post employment medical reserve must grow annually over the Long-Term Financial Plan with the budgetary inflation factor.

Liability and Property Insurance Fund

This fund was established in FY 2002/2003 to separate out liability and property insurance costs from the Employee Benefits and Insurance Fund. Separating these costs into its own fund provides better accountability of expenditures and allows the City to recover costs based on usage rather than on salary expenditures. Liability and Property Insurance for FY 2003/2004 includes moderate increases over the Long-Term Financial Plan.

<u>Sunnyvale Office Center Fund</u>

A new fund was established in the FY 2002/2003 Budget to account for the activities of the Sunnyvale Office Center located at 505 W. Olive Avenue, across from the main City Hall. The Sunnyvale Office Center was purchased in April 2001 by the issuance of variable rate Certificates of Participation (COPs) to provide expansion opportunities for the Civic Center Complex. Activities included in this fund are maintenance and operations of the office facility, capital projects, and debt service. Revenues to this fund consist of rental from outside tenants and City operations, and interest on reserves.

In FY 2002/2003, the remainder of the proceeds of the COPs was transferred in from the Capital Projects Fund, where they had originally been deposited. For FY 2003/2004 the interest earnings attributable to this fund that had previously been earned were transferred in from the Capital Projects Fund.

When the fund was established, it was projected that the existing office buildings would be operated and leased through FY 2005/2006, when a long-term solution to the City's office space problem could be in place. Subsequently, plans for a new civic center complex have been put on hold because of the City's financial situation. The FY 2003/2004 Long-Term Financial Plan therefore shows the complex being operated for an additional seven years. Increasing the length of operation causes the office complex to generate more net income than originally anticipated; this allows the Sunnyvale Office Center Fund to give a rebate to the General Fund of about $200,000 annually over the entire planning period.

Because of the age and general condition of the office buildings, it was necessary to propose capital improvements in the amount of $654,000 in order to keep the facility in working order for the additional years that it would be in operation. The capital improvements would begin in FY 2004/2005 and continue through FY 2006/2007.

CONCLUSION

As your City Manager, I am honored to have the opportunity to present to you my recommendations for the FY 2003/2004 Budget, the Ten-Year Resource Allocation Plan, and 20-year financial forecast. <u>Even in this period of economic difficulties, each fund is balanced to the twentieth year.</u>

Two final points need to be made. First, Sunnyvale's planning and financial management systems are providing the foundation on which we are building the solutions to the City's budget crisis. Without this foundation, we would have found ourselves unprepared to respond to a budget crisis of this magnitude. This budget crisis required that the City reduce the services and levels of service that we provide. Our planning and management systems provided the framework and the information in order for staff to make recommendations and for Council to make the final decisions.

Second, although we have recommended ways to close the General Fund structural gap, our job is not over. The very factors that created the budget crisis remain in place, and are very fluid. Staff will continue to pay close attention to local economic conditions, our revenue patterns and expenditure trends, and State legislative actions. Any changes to our strategies for addressing this budget crisis will be presented to the City Council for policy direction and final action.

The City's approach to budgeting and long-term financial planning is complex, and highly valued in this organization and in our community. In preparing the recommended FY 2003/2004 Budget and Ten-Year Resource Allocation Plan, I am fortunate to have had the support and assistance of exceptional staff who continually go beyond the call of duty. In particular, I would like to thank Chuck Schwabe, Deputy City Manager and Amy Chan, Assistant City Manager, who worked tirelessly on the 6-Point Action Plan and its implementation. I would also like to recognize the talented and dedicated budget team led by Mary Bradley, Director of Finance and Grace Kim, Finance Manager. These team members include Mark Eyrich, Kurtis Mock, and Charlene Sun along with the assistance of Tim Kirby, Nasi Raissian, and Pete Gonda.

Respectfully Submitted,

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Robert S. LaSala
City Manager

May 13, 2003